

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

In the Matter of the Application of)

MAUI ELECTRIC COMPANY, LIMITED)

DOCKET NO. 2011-0092

For Approval of Rate Increases and)

Revised Rate Schedules and Rules.)

DECISION AND ORDER NO. 31288

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DECISION AND ORDER

By this Decision and Order, the commission approves an increase in rates for MAUI ELECTRIC COMPANY, LIMITED ("MECO" or the "Company")¹ to such level as will produce, in the aggregate, \$5,334,000 in additional revenues, or 1.29%, over revenues at present rates (i.e., 2010 test year final rates)², based on an estimated total revenue requirement of \$418,901,000 (on a consolidated basis) for the January 1, 2012 to December 31, 2012 test year ("2012 Test Year") rather than MECO's initial request

¹The "Parties" to this proceeding are MECO and the DEPARTMENT OF COMMERCE AND CONSUMER AFFAIRS, DIVISION OF CONSUMER ADVOCACY ("Consumer Advocate"), an ex-officio party to this proceeding pursuant to Hawaii Revised Statutes ("HRS") § 269-51 and Hawaii Administrative Rules ("HAR") § 6-61-62(a). No persons timely moved to intervene or participate in this proceeding. See HAR § 6-61-57(3)(A).

²Unless specifically stated otherwise, "present rates" refer to the final rates established by the commission in Decision and Order No. 30365, filed on May 2, 2012, in Docket No. 2009-0163, the commission's final decision and order issued in MECO's 2010 test year rate case ("MECO 2010 Rate Case").

for an additional \$27,523,000 (or approximately 6.68%) over revenues at then current effective rates, as set forth in MECO's application filed on July 22, 2011.³ In so doing, the commission approves the Parties' Stipulated Settlement Letter, filed on April 20, 2012 (amended by the Parties' Revised Updated Stipulated Settlement Letter, filed on May 14, 2012, and supplemented by the Parties' Stipulated Supplement, filed on July 20, 2012), with the adjustments made by the commission in this Decision and Order.

The final revenue increase of \$5,334,000 approved in this Decision and Order is less than the revenue increase of \$13,089,000 previously approved by the commission on an interim basis.⁴ Thus, pursuant to HRS § 269-16(d), MECO must refund its ratepayers the amount it collected in excess of the increase authorized by this Decision and Order, together with interest. However, the commission acknowledges that the required refund to ratepayers will be tempered by the effects of the 2013 Revenue Balancing Account ("RBA") rate adjustment of MECO's decoupling mechanism, which takes effect on June 1, 2013.

³MECO's Application; Verification, Direct Testimonies; Exhibits; and Certificate of Service, filed on July 22, 2011 (collectively, "Application").

⁴See Interim Decision and Order No. 30396, filed on May 21, 2012, in the instant proceeding ("Interim Decision and Order").

I.

Background

MECO is a Hawaii corporation and a public utility as defined by HRS § 269-1.⁵ MECO is engaged in the production, purchase, transmission, distribution, and sale of electricity on the islands of Maui, Molokai, and Lanai in the State of Hawaii ("State").

MECO's affiliate entities, Hawaiian Electric Company, Inc. ("HECO") and Hawaii Electric Light Company, Inc. ("HELCO") are public utilities that provide electric utility services⁴ on the islands of Oahu and Hawaii, respectively.⁶

A.

MECO's Application

On July 22, 2011, MECO filed its Application⁷ seeking commission approval to increase its revenues by \$27,523,000 (or approximately 6.68%) over revenues at then current effective

⁵MECO was initially organized under the laws of the Territory of Hawaii on or about April 28, 1921.

⁶MECO, HECO, and HELCO are collectively referred to as the "HECO Companies." Structurally, MECO and HELCO are subsidiaries of HECO, while HECO is a subsidiary of Hawaiian Electric Industries, Inc. ("HEI").

⁷MECO concurrently served copies of its Application on the Consumer Advocate and the Mayor of the County of Maui. See Certificate of Service dated July 22, 2011.

rates.⁸ The requested increase was based on an estimated total revenue requirement of \$439,377,000 for the 2012 Test Year,⁹ and an 8.72% rate of return on MECO's average 2012 Test Year rate base of \$393,271,000. In addition, in its Application, MECO proposed to, among other things:

1. Implement its proposed rate changes in two stages (first as an "Interim Increase" equal to the increase in rates to which the commission determines MECO is "probably entitled" and then as a "Final Increase" when the commission issues its final written decision) and its proposed rate design changes with final rates;
2. Establish a purchased power adjustment clause/surcharge ("PPAC") to recover non-energy purchased power agreement cost, implement a revenue balancing account tariff for a revenue decoupling mechanism, and implement a revenue adjustment mechanism tariff, if not already approved in Docket No. 2009-0163, MECO's 2010 test year rate case;

⁸In its Application, MECO stated that its "current effective rates are the result of its existing 'base' rates, plus the \$8,513,000 adjusted interim rate increase approved on January 5, 2011 in MECO's pending 2010 test year rate case (Docket No. 2009-0163). MECO's existing base rates are the result of the Commission's Decision and Order, issued July 30, 2010, in Docket No. 2006-0387, which utilized a 2007 test year." See Application at 19.

⁹According to MECO, this revenue requirement is based on the depreciation rates and methods approved by the commission in its "Decision and Order, issued May 20, 2011 in MECO's 2008 book depreciation study proceeding, Docket No. 2009-0286[.]" See Application at 2 (emphasis in original).

3. Revise its energy cost adjustment clause ("ECAC") tariff to change the target heat rates by fuel type, apply heat rate deadbands, and establish conditions for changing the target heat rates (if not already approved in Docket No. 2006-0163); and
4. Implement a change in accounting for administrative and general ("A&G") transfers to construction projects based on the methodology recommended in a recent review of MECO's transfer of A&G expenses.

According to MECO, rate relief is needed due to "increased operations and maintenance expenses and additional investments in plant and equipment required to maintain and increase system reliability, meet expected load growth, and integrate increasing levels of renewable energy."¹⁰

B.

Public Hearings

The commission held public hearings on MECO's Application on October 18, 19 and 20, 2011, in Kahului, Maui; Lanai City, Lanai; and Kaunakakai, Molokai; respectively, pursuant to HRS §§ 269-16 and 269-12. Representatives from MECO, the Consumer Advocate, and the general public appeared and presented oral and written testimonies during the public hearings. In addition, the commission accepted written comments

¹⁰See Application at 21.

from the public regarding MECO's Application prior to and after the public hearings. In general, members of the public expressed concerns with and/or opposition to the increase in rates proposed by MECO.

C.

Procedural History

Pursuant to the Schedule of Proceeding of the Stipulated Prehearing Order, issued on September 9, 2011, in this docket, the Consumer Advocate issued and MECO responded to numerous information requests ("IRs"). On February 10, 2012, the Consumer Advocate filed its direct testimonies, exhibits, and workpapers. Then, MECO issued and the Consumer Advocate responded to various IRs regarding the Consumer Advocate's filings.

On March 14, 2012, MECO filed its rebuttal testimonies, exhibits, and workpapers. Thereafter, the Consumer Advocate issued and MECO responded to certain rebuttal IRs.

On April 2, 2012, the Parties began settlement discussions.

By letter filed on April 17, 2012, the Parties jointly informed the commission that they had reached agreement on all issues in MECO's 2012 Test Year rate case and, thus, stipulate to and request that the commission waive various procedural

steps including the prehearing conference, evidentiary hearing, and the filing of simultaneous briefs.

On April 20, 2012, the Parties filed their Stipulated Settlement Letter ("Settlement Agreement") and their Joint Statement of Probable Entitlement. In their filings, the Parties state that they have reached a "global settlement on all issues in this proceeding[.]"¹¹ According to the Parties, the rate changes set forth in their Settlement Agreement "result in just and reasonable rates for MECO's regulated electric operations."¹² As such, the Parties request that the commission "approve [their] settlement agreement in its interim and final decision and orders for this proceeding."¹³

On May 3, 2012, the commission issued Order No. 30368 Instructing the Parties to File an Updated Joint Statement of Probable Entitlement and Stipulated Settlement Letter ("Order No. 30368"). In that order, the commission instructed the Parties to update their filings to reflect the commission's rulings and decisions made in Decision and Order No. 30365, filed on May 2, 2012, in Docket No. 2009-0163, the commission's

¹¹See Settlement Agreement at 1 (emphasis in original).

¹²Id.

¹³Id.

decision and order approving final rates in the MECO 2010 Rate Case.¹⁴

On May 9, 2012, the Parties submitted their Updated Joint Statement of Probable Entitlement and Updated Stipulated Settlement Letter ("Updated Settlement Agreement"), pursuant to Order No. 30368. According to the Parties, Exhibit 1A of the Updated Settlement Agreement updates Exhibit 1 of the Parties' Settlement Agreement, filed on April 20, 2012, and "only includes those sections of the Settlement Agreement that have changed."¹⁵ Among other things, consistent with the commission's instructions the Parties updated their filings to reflect the commission's decisions made in the MECO 2010 Final, and updated the supporting schedules to incorporate the impact of the implementation of the final rates approved in the MECO 2010 Rate Case. However, upon detecting a calculation error in their May 9, 2012 filings, on May 14, 2012, the Parties submitted their Revised Updated Joint Statement of Probable Entitlement and Revised Updated Stipulated Settlement Letter with

¹⁴See In re Maui Electric Company, Limited, Docket No. 2009-0163, Decision and Order No. 30365, filed on May 2, 2012 ("MECO 2010 Final").

¹⁵See Updated Settlement Agreement at 1.

accompanying attachments and exhibits.¹⁶ Thus, the Settlement Agreement, filed on April 20, 2012, as amended by the Revised Updated Stipulated Settlement Letter, filed on May 14, 2012, is hereafter collectively referred to as the "Revised Settlement Agreement."¹⁷

On May 21, 2012, the commission issued its Interim Decision and Order in this proceeding, approving, for interim purposes only, an increase in revenues of \$13,089,000 (or approximately 3.16%) over revenues at present rates, based on a total revenue requirement of \$426,656,000, on a consolidated operations basis, for the 2012 Test Year. In the Interim Decision and Order, the commission also authorized MECO to reset its target heat rates by fuel type to 2012 Test Year levels for the purpose of calculating its ECAC. In addition, for interim purposes, commission approved the Parties' agreements regarding:

¹⁶According to the Parties, the Revised Updated Stipulated Settlement Letter, filed on May 14, 2012, supersedes their Updated Settlement Agreement filed on May 9, 2012.

¹⁷The Parties note that Exhibit 1A (Revised 5/14/12) attached to the Revised Updated Settlement Letter provides updates to Exhibit 1 of the Parties' Settlement Agreement, filed on April 20, 2012, and that "Exhibit 1A (Revised 5/14/12) only includes those sections of the Settlement Agreement that have changed" due to the impact of the final rates approved in the MECO 2010 Rate Case. See Revised Updated Settlement Letter at 2 (emphasis omitted). Thus, when referring to certain portions of the Parties' settlement, the commission will specifically refer to "Settlement Agreement, Exhibit 1" and "Revised Settlement Agreement, Exhibit 1A", as applicable.

(1) Customer Information System ("CIS") project costs and CIS project related regulatory commission expenses; (2) corporate administrative transfer accounting changes (with an effective date of January 1, 2012); (3) the allocation of employee benefits expense accounting changes; and (4) integrated resource plan ("IRP") expenses. Finally, among other things, the commission approved the Parties' agreement to waive the evidentiary hearing and related procedural steps, as set forth in their April 17, 2012 joint letter and in the Settlement Agreement.¹⁸

Subsequently, the commission issued various clarifying IRs to address certain concerns outlined in the Interim Decision and Order for which the Parties filed responses to on May 10, August 10, November 28 and 30, 2012, among other instances.

On July 20, 2012, the Parties filed a Stipulated Supplement to their Settlement Agreement, filed on April 20, 2012, which was revised by their May 14, 2012 filing, referred hereto as the Revised Settlement Agreement ("Stipulated Supplement"). In their Stipulated Supplement, the Parties propose to reduce MECO's 2012 Test Year revenue requirements to incorporate actual regulatory commission expense incurred through the date of the Stipulated Supplement, which includes

¹⁸See Interim Decision and Order at 37.

accruals, and to remove the allocated portion of non-incentive executive compensation costs and allocations of miscellaneous administrative expenses from HEI, together with associated adjustments to the accumulated deferred income taxes ("ADIT") and working cash components of rate base.¹⁹ The Parties elaborate as follows:

[P]ursuant to this stipulation, the Parties agree: (1) to a net reduction of \$129,000 to the MECO 2012 test year revenue requirement from \$426,656,000 to \$426,527,000, and to the revenue increase for the MECO 2012 test year from \$13,089,000 to \$12,960,000 over revenues at present rates (i.e., 2010 test year final rates), and (2) that pursuant to Section 269-16(d) of the Hawaii Revised Statutes, should the interim revenue requirement of this rate case be in excess of the final revenue requirement approved by the Commission, MECO will refund to customers the excess, plus accumulated interest, through a separate rate adjustment, upon implementation of Commission-approved final rates in this rate case.

Stipulated Supplement at 1-2 (emphasis in original, footnote omitted). Based on the foregoing, the Parties request that the commission approve a reduction of \$129,000 to the 2012 Test Year revenue requirements, as reflected in Exhibit 1 of their Stipulated Supplement, in the commission's final decision and order for this proceeding.²⁰

¹⁹See Stipulated Supplement at 1.

²⁰See id. at 4.

D.

Audit Stipulation

In Docket No. 2008-0083 (i.e., the "HECO 2009 Rate Case"), the commission approved the Consumer Advocate's recommendation for focused regulatory audits of HECO's East Oahu Transmission Project ("EOTP"), the Campbell Industrial Park Transmission Turbine Unit ("CIP CT-1"), and the CIS project.²¹

In this proceeding, the commission in the Interim Decision and Order approved the Parties' agreement to treat CIS project costs as they had agreed to do so in the HECO 2011 Rate Case.²² In that proceeding, the parties agreed to defer certain project costs and continue to accrue allowance for funds used during construction ("AFUDC") until the regulatory audit of the CIS project ordered in the HECO 2009 Rate Case is completed, the commission has approved the reasonableness of the project's costs, and the commission issued an order for a rate adjustment

²¹See In re Hawaiian Electric Company, Inc., Order Approving Consumer Advocate's Recommendations Regarding Focused Regulatory Audits, filed on May 2, 2011, in Docket No. 2008-0083. Subsequently, the costs of the EOTP were settled in Docket No. 2010-0080 (i.e., the "HECO 2011 Rate Case") and the commission decided that an audit would not be conducted for EOTP Phase 1. See In re Hawaiian Electric Company, Inc., Order No. 30287 Approving Joint Motion of Hawaiian Electric Company, Inc., the Division of Consumer Advocacy, and the Department of Defense to Adjust Interim Increase, filed on March 29, 2012, in Docket No. 2010-0080, at 17.

²²See Interim Decision and Order at 16-20.

to include the project costs in rates.²³ The Parties agreed that the rate adjustment required upon completion of the CIS audit would reflect the revenue requirements related to the deferred costs of the CIS project that were found to be prudently incurred, include deferred CIS project operations and maintenance ("O&M") expenses in rate base, and the associated amortized expense.²⁴

Subsequently, on January 28, 2013, the HECO Companies and the Consumer Advocate jointly filed a Stipulated Settlement Agreement ("Audit Stipulation") regarding the regulatory audits of the CIP CT-1 and CIS projects in the HECO 2009 Rate Case.²⁵ Under the stipulation, the HECO Companies would write-off, for accounting and ratemaking purposes, a total of \$40 million of recorded capitalized costs in lieu of conducting regulatory audits of the two projects.²⁶ With respect to the proposed write-off, the HECO Companies and the Consumer Advocate agreed that: (1) the write-off amount is in addition to any credits received from the CIS project vendor; (2) the full amount of the

²³See id. at 17.

²⁴See id. at 17-18.

²⁵See In re Hawaiian Electric Company, Inc., Order No. 31126 Approving, with Clarifications, Stipulated Settlement Agreement, Filed on January 28, 2013, filed on March 19, 2013, in Docket No. 2008-0083 ("Order No. 31126"), at 3.

²⁶See id. at 3-4.

write-off would be associated with the CIS project, \$29 million for HECO, \$5.5 million for HELCO, and \$5.5 million for MECO; (3) the net recoverable costs for the CIP CT-1 and CIS projects would be included in rate base as of December 31, 2012; and (4) the HECO Companies would include the net recoverable costs of the projects, not already included in rates, in their 2013 Rate Adjustment Mechanism ("RAM") revenue adjustments.²⁷ In addition, the HECO Companies and the Consumer Advocate agreed that, among other things, HELCO will withdraw its 2013 test year rate case (i.e., Docket No. 2012-0099), HECO will delay the filing of its 2014 test year rate case and, with respect to MECO, they agreed to the following:

MECO and the Consumer Advocate continue to support the Parties [sic] Stipulated Settlement in the MECO 2012 test year rate case (Docket No. 2011-0092). Given the other portions of this 2008-0083 agreement, particularly in terms of the maintenance of the current financial structure and mechanisms, MECO and the Consumer Advocate even more strongly support the agreements set forth in the Parties [sic] Stipulated Settlement in the MECO 2012 test year rate case related to: (a) the rate of return on common equity used to determine the fair rate of return on rate base, (b) the ECAC, (c) the pension/OPEB tracking mechanisms, (d) decoupling and (e) the PPAC.

Order No. 31126 at 5-6 (footnote omitted).

²⁷See id. at 4.

On March 19, 2013, the commission issued Order No. 31126 in the HECO 2009 Rate Case approving the Audit Stipulation, subject to certain clarifications. In that order, the commission clarified that by approving the Audit Stipulation, it "is not bound by" the HECO Companies and the Consumer Advocate's statements in the HECO 2009 Rate Case regarding Docket No. 2011-0092 (i.e., this docket) issues, as set forth above, and that the commission "will more appropriately rule on the substance of the MECO settlement in Docket No. 2011-0092."²⁸ In addition, the commission in Order No. 31126 ordered that HECO shall no longer be required to undergo the regulatory audits of its CIP CT-1 and CIS projects.²⁹

E.

Issues

As stipulated to by the Parties,³⁰ the issues in this proceeding are:

1. Is MECO's proposed rate increase reasonable?
 - a. Are the proposed tariffs, rates, charges and rules just and reasonable?

²⁸Id. at 10.

²⁹See id. at 11.

³⁰See Stipulated Prehearing Order, filed on September 9, 2011, at 2-3.

- b. Are the revenue forecasts for the 2012 test year at current effective rates, and proposed rates reasonable?
 - c. Are the projected operating expenses for the 2012 test year reasonable?
 - d. Is the projected rate base for the 2012 test year reasonable and are the properties included in rate base used or useful for public utility purposes?
 - e. Is the requested rate of return fair?
- 2. What is the amount of the Interim Rate Increase, if any, to which MECO is probably entitled under § 269-16(d) of the HRS?
 - 3. If not already approved in Docket No. 2009-0163, is the proposed PPAC to recover non-energy purchased power agreement costs just and reasonable?
 - 4. If not already approved in Docket No. 2009-0163, is the proposed RBA tariff (including the modifications proposed in this docket) for a revenue decoupling mechanism to be effective at such time that interim rates become effective pursuant to the interim decision and order in this rate case just and reasonable?
 - 5. If not already approved in Docket No. 2009-0163, is the proposed RAM tariff (including the modifications proposed in this docket) to be effective at such time that interim rates become effective pursuant to the interim decision and order in this rate case just and reasonable?

6. Is the proposed revision to the ECAC tariff to (1) change the target heat rate by fuel type, (2) apply the heat rate deadbands proposed in the decoupling proceeding to the target heat rates, and (3) establish conditions for changing the target heat rates proposed in the decoupling proceeding, to be effective at such time that interim rates become effective pursuant to the interim decision and order in this rate case just and reasonable?
7. Is the proposed change in accounting for A&G transfers to construction projects at the time that electric rates go into effect from either an interim or final decision and order in this rate case just and reasonable?

II.

Discussion

HRS § 269-16 states in relevant part:

Regulation of utility rates; ratemaking procedures. (a) All rates, fares, charges, classifications, schedules, rules, and practices made, charged, or observed by any public utility or by two or more public utilities jointly shall be just and reasonable and shall be filed with the public utilities commission. The rates, fares, classifications, charges, and rules of every public utility shall be published by the public utility in such manner as the public utilities commission may require, and copies shall be furnished to any person on request.

To the extent the contested case proceedings referred to in chapter 91 are required in any rate proceeding to ensure fairness and to provide due process to parties that may be affected by rates approved by the commission, the evidentiary hearings shall be conducted expeditiously and shall be conducted as a part of the ratemaking proceeding.

(b) No rate, fare, charge, classification, schedule, rule, or practice, other than one established pursuant to an automatic rate adjustment clause previously approved by the commission, shall be established, abandoned, modified, or departed from by any public utility, except after thirty days' notice to the commission as prescribed in section 269-12(b), and prior approval by the commission for any increases in rates, fares, or charges A contested case hearing shall be held in connection with any increase in rates, and the hearing shall be preceded by a public hearing as prescribed in section 269-12(c), at which the consumers or patrons of the public utility may present testimony to the commission concerning the increase. The commission, upon notice to the public utility, may:

(1) Suspend the operation of all or any part of the proposed rate, fare, charge, classification, schedule, rule, or practice or any proposed abandonment or modification thereof or departure therefrom;

(2) After a hearing, by order:

(A) Regulate, fix, and change all such rates, fares, charges, classifications, schedules, rules, and practices so that the same shall be just and reasonable;

(B) Prohibit rebates and unreasonable discrimination between localities or between users or consumers under substantially similar conditions;

(C) Regulate the manner in which the property of every public utility is operated with reference to the safety and accommodation of the public;

- (D) Prescribe its form and method of keeping accounts, books, and records, and its accounting system;
- (E) Regulate the return upon its public utility property;
- (F) Regulate the incurring of indebtedness relating to its public utility business; and
- (G) Regulate its financial transactions; and

(3) Do all things that are necessary and in the exercise of the commission's power and jurisdiction, all of which as so ordered, regulated, fixed, and changed are just and reasonable, and provide a fair return on the property of the utility actually used or useful for public utility purposes.

.

- (d) The commission shall make every effort to complete its deliberations and issue its decision as expeditiously as possible and before nine months from the date the public utility filed its completed application; provided that in carrying out this mandate, the commission shall require all parties to a proceeding to comply strictly with procedural time schedules that it establishes. If a decision is rendered after the nine-month period, the commission shall report in writing the reasons therefor to the legislature within thirty days after rendering the decision.

Notwithstanding subsection (c), if the commission has not issued its final decision on a public utility's rate application within the nine-month period stated in this section, the commission, within one month after the expiration of the nine-month period, shall render an interim decision allowing the increase in rates, fares and charges, if any, to which the commission,

based on the evidentiary record before it, believes the public utility is probably entitled. The commission may postpone its interim rate decision for thirty days if the commission considers the evidentiary hearings incomplete. In the event interim rates are made effective, the commission shall require by order the public utility to return, in the form of an adjustment to rates, fares, or charges to be billed in the future, any amounts with interest, at a rate equal to the rate of return on the public utility's rate base found to be reasonable by the commission, received under the interim rates that are in excess of the rates, fares, or charges finally determined to be just and reasonable by the commission. Interest on any excess shall commence as of the date that any rate, fare, or charge goes into effect that results in the excess and shall continue to accrue on the balance of the excess until returned.

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HRS § 269-16.

MECO filed its Application on July 22, 2011. Accordingly, the nine-month deadline for the commission to complete its deliberations and issue its decision and order expired on or about April 22, 2012, under HRS § 269-16(d); provided that the Parties strictly comply the procedural time schedules established by the commission. Instead of issuing a commission decision and order by that date, the commission, on May 21, 2012, timely issued the Interim Decision and Order, in compliance with HRS § 269-16(d).

Through this Decision and Order the commission issues its final decisions regarding this proceeding.

A.

Revised Settlement Agreement

The Parties' Revised Settlement Agreement, as later supplemented, represents their global settlement of all of the issues of this proceeding. The Parties note that:

The agreements [of their settlement] . . . are for the purpose of simplifying and expediting this proceeding, and represent a negotiated compromise of the matters agreed upon, and do not constitute an admission by any party with respect to any of the matters agreed upon herein. The Parties expressly reserve their right to take different positions regarding the matters agreed to herein in other proceedings.

Revised Settlement Agreement at 5.

Nonetheless, the Parties request and, thus, recognize that their Revised Settlement Agreement, as later supplemented, is ultimately subject to the commission's review and approval.

Consistent with the commission's review regarding similar such agreements, the commission makes clear that an agreement between the parties in a rate case cannot bind the commission, as the commission has an independent obligation to

set fair and just rates and arrive at its own conclusions.³¹ In re Hawaiian Electric Co., Inc., 5 Haw. App. 445, 447, 698 P.2d 304, 307 (1985).

With this in mind, the commission proceeds in its review of determining whether the Parties' Revised Settlement Agreement, as later supplemented, is just and reasonable.

B.

Operating Revenues³²

In the Interim Decision and Order, the commission approved MECO's request to reset its target heat rates by fuel type to 2012 Test Year levels.³³ Under this scenario,³⁴ the

³¹See MECO 2010 Final at 19-20. See In re The Gas Company, Decision and Order issued on April 20, 2010, in Docket No. 2008-0081, at 17.

³²With respect to this and other rate-related items, due to rounding, minor discrepancies exist between certain figures in the record and the commission's Decision and Order and accompanying exhibits. In addition, unless specifically noted otherwise, each amount or figure set forth in this Decision and Order is on a consolidated basis for MECO.

³³See Interim Decision and Order at 35. MECO in its direct testimony indicated that it will be proposing to adjust its target heat rate at that time Sempra's proposed 21 megawatt ("MW") wind farm in Ulupalakua achieves the commercial operation date (targeted to be in 2013 and before MECO's next planned rate case) which is a product of MECO's power purchase agreement with Auwahi Wind Energy ("Auwahi"). See MECO T-5 at 17-18. MECO shall file all appropriate documentation regarding the re-setting of its target heat rate with respect to Auwahi.

Parties agree to operating revenues at present rates (on a consolidated basis) as follows³⁵:

<u>Operating Revenues</u>	<u>Present Rates</u>
Electric Sales	\$411,657,000
Other Operating Revenues	1,910,000
Total Operating Revenues	\$413,567,000

1.

Electric Sales

According to MECO, electric sales revenues include revenues from base electric charges, revenues from the Firm Capacity Surcharge Adjustment (Maui Division only), and revenues from the ECAC.³⁶ MECO's base electric charges consist of: (1) customer, demand, energy, and minimum charges; and (2) the power factor, service voltage, and other adjustments, as provided in each rate and rate rider schedule.³⁷ "The Firm

³⁴According to the Parties, had the commission declined to allow MECO to reset its target heat rates to 2012 Test Year levels for interim purposes (i.e., retained 2010 test year target heat rates), MECO's total revenues at present rates would be \$408,463,000, on a consolidated basis, and would result in additional revenues of \$18,194,000 as opposed to \$13,089,000, which was approved in the Interim Decision and Order. See Revised Settlement Agreement at 3-4.

³⁵See Revised Settlement Agreement, Exhibit 1A at 4 and 5; MECO T-22 Attachment 1A at 1. See also Revised Settlement Agreement at 4.

³⁶See MECO T-4 at 4.

³⁷See id.

Capacity Surcharge Adjustment is based on collecting for additional capacity payments and emergency energy purchases plus associated revenue taxes resulting from Hawaiian Commercial & Sugar Company ("HC&S")."³⁸ ECAC, on the other hand, is an "automatic adjustment provision in the utility's rate schedules that allows the utility to automatically increase or decrease charges to reflect the change in the Company's energy costs of fuel and purchased energy above or below the levels included in the base charges without a rate proceeding."³⁹

For the 2012 Test Year, the Parties stipulate to an average number of customers of 68,755 and electric sales of 1,201,761 megawatt-hours ("MWh"), on a consolidated basis, as initially estimated by MECO in its direct testimony.⁴⁰ MECO's 2012 Test Year estimates for number of average customers and electric sales was based on MECO's 2011-2045 Sales and Peak Forecasts, which was adopted by MECO's Forecast Planning Committee in March 2011.⁴¹ The 2012 Test Year estimates were based on the customer service analysis method which "takes into consideration Hawaii economists' projections of different

³⁸MECO T-4 at 7-8.

³⁹Id. at 10.

⁴⁰See Settlement Agreement, Exhibit 1 at 13-14.

⁴¹See MECO T-3 at 2-3.

economic indices that show a high correlation to sales, time series analysis, and customer specific knowledge."⁴² The Consumer Advocate accepted as reasonable MECO's estimates for electric sales and average number of customers for the 2012 Test Year, based on the Consumer Advocate's determination that the methods employed by MECO in developing its forecasts appear reasonable and that the results produced by the methods are tracking closely to consolidated recorded actual sales figures and customer count data.⁴³

Due to differing production simulation results, the Consumer Advocate made an adjustment to MECO's estimate for ECAC revenues. Specifically, the Consumer Advocate adjusted MECO's calculation to include a fuel oil adjustment to account for the consumption of used lube oil at MECO's Kahului Power Plant ("KPP").⁴⁴ According to the Consumer Advocate, the adjustment passes "fuel expense savings associated with the consumption of IFO⁴⁵ at [KPP] through to customers."⁴⁶ For settlement purposes,

⁴²Id. at 3.

⁴³See CA-T-2 18-19.

⁴⁴See CA-T-2 at 22-23; CA-T-3 at 19.

⁴⁵"IFO" is the acronym for Intermediate Fuel Oil.

⁴⁶CA-T-3 at 19-20 (footnote added).

MECO accepted the Consumer Advocate's adjustment.⁴⁷ With this adjustment and the commission's issuance of the MECO 2010 Final, the Parties stipulate to 2012 Test Year electric sales revenues at present rates with target heat rates reset by fuel type at 2012 Test Year levels of \$411,657,000.⁴⁸

The forecast with respect to electric sales and average customer count are reasonable given that they appear to track actual figures, and the adjustment to MECO's initial ECAC revenue figure as described above and set forth in the record is acceptable. Thus, the commission finds the Parties' agreement of \$411,657,000 (on a consolidated basis) for 2012 Test Year electric sales revenues at present rates to be reasonable.

2.

Other Operating Revenues

MECO's other operating revenues is comprised of revenues collected for various activities including, but not limited to, return check and late payment charges, field collection charges, service establishment and reconnection charges, and rents from electric property (which includes

⁴⁷See MECO RT-4 at 3; MECO RT-7 at 2-4. See also Revised Settlement Agreement, Exhibit 1A at 4.

⁴⁸See Revised Settlement Agreement, Exhibit 1A at 4.

revenues from street light fixtures, pole rentals and the Lanai combined heat and power facilities charge).⁴⁹

For the 2012 Test Year, the Parties stipulate to other operating revenues of \$1,909,000 (on a consolidated basis) at present rates. This figure is based on MECO's initial estimate of \$1,869,000, and a \$40,000 upward adjustment proposed by the Consumer Advocate to account for revised figures for telecommunications related revenues for Molokai, rent revenues for street light fixtures, and field collection charges, to which MECO agreed.⁵⁰

The commission finds reasonable the Parties' consolidated estimate of \$1,910,000 (rounded) in other operating revenues at present rates for the 2012 Test Year.

3.

Total Operating Revenues

In sum, the commission approves as reasonable total operating revenues of \$413,567,000 (on a consolidated basis) at present rates for MECO's 2012 Test Year. This amount is

⁴⁹A detailed description of the specific accounts and activities that make up MECO's other operating revenues is set forth in MECO-912 at 2-8.

⁵⁰See Revised Settlement Agreement, Exhibit 1A at 5-6. See also MECO RT-9 at 3; MECO-R-901 at 1; MECO-R-902 at 2; and MECO-RWP-902 at 2.

consistent with the amount the commission previously approved for total operating revenues at present rates for interim purposes.⁵¹

C.

Operating Expenses

1.

O&M Expenses

As set forth in their Settlement Agreement, as revised and later supplemented, the Parties agree to the following O&M expenses at present rates:⁵²

<u>O&M Expenses</u>	<u>Present Rates</u>
Fuel	\$212,580,000
Purchased Power	44,856,000
Production	27,818,000
Transmission	2,963,000
Distribution	10,151,000
Customer Accounts	4,917,000
Allowance for Uncoll. Accounts	301,000
Customer Service	1,986,000
Administration & General	16,524,000
Total O&M Expenses	\$322,096,000

a.

Commission Concerns

While the commission determined that MECO was "probably entitled" to interim rate relief and approved an increase in rates for interim purposes, the commission did so with the

⁵¹See Interim Decision and Order, Exhibit A.

⁵²See Stipulated Supplement, Exhibit 1 at 1.

qualification that the commission's determination of interim rate relief:

. . . is necessarily quick, unlike the careful deliberation the commission consistently accords issues in rendering final decisions. In deciding interim rate relief, the commission must often postpone determinations of reasonableness with respect to certain unresolved matters. Otherwise, the speed with which [the public utility] is given interim rate relief would be affected.

Interim Decision and Order at 10, n.16 (citations omitted).

In the Interim Decision and Order, the commission stated various concerns regarding MECO's O&M expenses.⁵³ Generally, the commission expressed that the increase in rates for the 2012 Test Year appear to be driven by higher O&M expenses, and noted that "MECO's requested O&M expense in the instant docket represented over a 50% increase from the O&M expense level approved by the commission in MECO's 2007 test year rate case."⁵⁴ The commission stated specific concerns regarding: (1) executive compensation of MECO's ultimate holding company, HEI, (2) CIS project costs in rates, and (3) increases in employee benefits; and remarked that these O&M expenses required further scrutiny.⁵⁵

⁵³See Interim Decision and Order at 30.

⁵⁴Id., n.47.

⁵⁵See id. at 31-32.

Upon the issuance of the Interim Decision and Order, the Parties entered into a subsequent agreement to: (1) reflect actual regulatory commission expenses incurred; and (2) remove from MECO's 2012 Test Year expenses the allocated portion of non-incentive executive compensation costs and the allocation of miscellaneous administrative expenses from HEI, resulting in a net reduction of revenue requirements, as set forth in the Parties' Stipulated Supplement.⁵⁶ Later, the HECO Companies and the Consumer Advocate came to terms with respect to the audit of the CIS project and stipulated to a write-down of \$5.5 million of deferred CIS costs for MECO.

During the 2013 session, the Hawaii State Legislature ("Legislature") expressed strong concerns regarding the increasing cost of electricity in the State. Specifically, the Legislature asserted the following:

The legislature finds that electricity rates in the State are at record levels, due in large part to the high cost of petroleum used to fuel electric generation plants on all islands. In addition, electric utility operating expenses have substantially increased in recent years while electric sales have declined. The consequences of those circumstances have led to further electricity rate increases. Electric ratepayers are demanding immediate relief from increasing electricity rates. It is therefore imperative that Hawaii's electric utilities

⁵⁶See Stipulated Supplement at 1.

accelerate their efforts to acquire lower cost clean energy resources and reduce existing energy and other utility operating expenses.

Senate Bill No. 120, Senate Draft 1 at 1.⁵⁷

Echoing the concerns articulated by the Legislature in Act 37, and upon further review and due to concerns arising from Docket No. 2012-0036, the HECO Companies' current IRP proceeding, the commission finds it reasonable and prudent to adjust certain additional O&M expenses as discussed in detail below.

i)

CIS Related Costs in Rates

CIS, or the Customer Information System "is a new system that consists of hardware and software, including support system software that will replace . . . the existing ACCESS customer information system and serve" the HECO Companies.⁵⁸

On May 3, 2005, the commission issued Decision and Order No. 21798 in Docket No. 04-0268 ("CIS D&O"), approving: (1) the request of the HECO Companies to expend approximately \$20,350,000 (provided that no amount of the costs of the project

⁵⁷Senate Bill No. 120, Senate Draft 1 was signed into law on April 22, 2013, as Act 37, Session Laws of Hawaii ("SLH") 2013 ("Act 37").

⁵⁸MECO T-18 at 2.

may be included in the HECO Companies' rate bases unless and until the project is in fact installed, and is used and useful for public utility purposes), and (2) certain accounting requests.⁵⁹ Rather than the projected twenty-four month completion date and estimated costs set forth in the HECO Companies' application,⁶⁰ the CIS project was not completed until September 30, 2012, and the final cost of the CIS project increased to approximately \$77,681,000, excluding certain AFUDC accruals for HECO and MECO.⁶¹ Due to project delays and escalating costs, the commission ordered a regulatory audit of the CIS project in the HECO 2009 Rate Case. In January 2013, as discussed above, the Consumer Advocate and the HECO Companies entered into the Audit Stipulation to write-off a portion of the deferred costs, and to include the remainder of the costs, not already in rates, in rate base, which the commission approved with clarifications on March 19, 2013.⁶²

⁵⁹See CIS D&O at 42.

⁶⁰See HECO Companies' CIS project application filed on August 26, 2004, in Docket No. 04-0268.

⁶¹See HECO's letters to the commission dated October 4, 2012 and April 1, 2013, filed in Docket No. 04-0268.

⁶²See Order No. 31126.

For MECO's 2012 Test Year, the Parties agreed to include into rates \$1,036,000 in O&M expenses related to the CIS project, which MECO explains as follows:

The \$1,036,000 that is included in the MECO 2012 test year represent CIS Project expenses associated with the development and implementation of the new CIS system (\$203,000 and \$394,000, totaling \$597,000 [for CIS O&M non-labor and labor expenses], and normalized post-CIS Project costs (\$439,000) for the stabilization period which will last approximately sixteen months after the end of the Project[.]

MECO's response to PUC-IR-12 at 1 (footnote omitted).

With respect to the \$439,000 in O&M costs in the 2012 Test Year for normalized post-CIS project expenses, MECO states that:

. . . following the CIS Project, the Hawaiian Electric Companies will deploy an augmented support organization to resolve system issues, assist end-users and support Customer Service initiatives during the stabilization period. The stabilization period will last approximately sixteen (16) months, and is currently anticipated to take place between September 2012, through the end of 2013. The total operation and maintenance costs for the stabilization period were estimated to be \$204,633 in 2012, \$799,114 in 2013. Costs for the ongoing maintenance and operation of the system after the stabilization period is estimated at \$311,961 in 2014, and along with the costs for 2012 and 2013, amount to a normalized total of \$438,569 of O&M expense.

MECO's response to PUC-IR-3 at 1-2 (footnote omitted).

Here, based on the record, the commission accepts as reasonable the inclusion of: (1) \$597,000 for CIS labor and non-labor O&M expenses associated with the development and implementation of the CIS project; and (2) 2012 projected costs for project stabilization (i.e., \$204,633), as stipulated to by the Parties. However, the commission is concerned about the inclusion of 2013 and 2014 estimated costs in the calculation of 2012 Test Year rates. The commission finds that the record does not sufficiently support inclusion of the proposed 2013 and 2014 estimated costs and, thus, rejects inclusion of such costs as unreasonable. First, the 2013 amount of \$799,114 is an estimated figure; it is uncertain how much of this amount will actually be expended in 2013. Second, since these O&M costs are associated with the stabilization period of the CIS project, it can be argued that these O&M expenses should be normalized over the useful life of the asset which caused the expense (i.e., twelve years) rather than three short years. Finally, the 2014 projected costs of \$311,961 included in the calculation for the stabilization period appear to be on-going O&M expenses for the CIS after the stabilization period is projected to be completed, at the end of 2013. The commission is uncertain why this amount was included in the calculation since estimated normal (or on-going) O&M expenses for 2014 should not be recovered during the 2012 Test Year.

Based on the foregoing, the commission finds it reasonable and appropriate to adjust the Parties' stipulated amount for post-CIS project O&M expenses associated with the stabilization period downward by \$233,936 (i.e., \$438,569 - \$204,633). With this adjustment, the commission finds it reasonable to allow recovery of \$204,633 for 2012 post-CIS project costs for the stabilization period and \$597,000 for CIS labor and non-labor O&M expenses associated with the development and implementation of the CIS in the 2012 Test Year.

ii)

Employee Benefits Expense

Employee benefits expense is comprised of expenses related to providing pension and other employee benefits to MECO's employees.⁶³ These expenses are included in MECO's A&G O&M expenses, net of amounts transferred to construction and to other accounts.⁶⁴ The types of employee benefits offered by MECO include pension, long-term disability, group medical, group dental, group vision, group life insurance, and long term care insurance. A complete list of MECO's employee benefits is set forth on page 29 of MECO T-12.

⁶³See MECO T-12 at 28.

⁶⁴See id. at 28-29.

To determine the appropriate level of pension expenses to be included in rates, MECO tracks pension costs separately through its pension tracking mechanism, a mechanism which is currently used by all of the HECO Companies. The pension tracking mechanism, as first explained during the HELCO 2006 test year rate case ("HELCO 2006 Rate Case"), is described as follows:

[U]nder the proposed pension tracking mechanism, an amount is identified in each rate case as pension costs in rates, and once new rates are effective and until rates are changed in a subsequent rate case, the amount of pension costs is separately tracked. Under the mechanism, HELCO would fund pension contributions at the actuarially calculated NPPC as determined under generally accepted accounting principles subject to certain exceptions. During each rate case, the cumulative amount of pension costs in rates since the last rate proceeding is compared to the cumulative amount of contributions to the pension fund and this net amount is an addition (if the cumulative contribution exceeds the cumulative amount in rates) or deduction (if the cumulative amount in rates exceeds the cumulative contribution) in the calculation of rate base. Then the test year ending pension balance in rate base is amortized over five years beginning when new rates are effective.

See In re Hawaii Electric Light Company, Inc., Docket No. 05-0315, Decision and Order, issued on October 28, 2010 ("HELCO 2006 Final") at 43-44. MECO uses a similar mechanism to track post-retirement benefits other than pension ("OPEB") costs, which is known as the OPEB tracking mechanism. The

commission first approved the pension and OPEB tracking mechanisms during the HELCO 2006 Rate Case.⁶⁵

For the 2012 Test Year, MECO initially proposed employee benefits expenses of \$8,822,000 on a consolidated basis.⁶⁶ This amount excludes employee benefit transfers of \$2,755,000. Based on updated net periodic pension cost ("NPPC") and net periodic benefits cost ("NPBC") figures provided by MECO's actuary, the Parties negotiated and ultimately stipulated to total A&G employee pensions and other benefits of \$8,975,000, on a consolidated basis (net of \$3,981,000 transferred to construction and other accounts) for 2012 Test Year.⁶⁷

Upon review, the commission finds the Parties' stipulation for employee benefits expense of \$8,975,000 for the 2012 Test Year to be unreasonable. This stipulated amount is \$3,199,500 (or approximately 55.4%) more than what was approved by the commission in the MECO 2010 Rate Case, wherein the commission approved \$5,775,500 for employee benefits expense, which is illustrated in the diagram below.

⁶⁵See HELCO 2006 Final at 46.

⁶⁶See MECO T-12 at 29. See also MECO-1201 at 1 (column 1).

⁶⁷See Settlement Agreement, MECO T-12, Attachment 1 (Final Settlement) at 1.

	Settlement 2010	Settlement 2012	Difference in \$\$	Difference in %
Pensions⁶⁸	\$4,375,000	\$ 8,969,000	\$4,594,000	105.0%
Other Post Retirement Benefits	623,600	507,000	(116,600)	(18.7%)
Defined Contributions		40,000	40,000	
Other Benefits (Vision, etc.)	3,189,900	3,661,000	471,100	14.8%
MECO Adjustments	(81,600)	(222,000)	(140,400)	
Rounding		1,000	1,000	
Total Employee Benefits	\$8,106,900	\$12,956,000	\$4,849,100	59.8%
Employee Benefits Transfers	(2,331,400)	(3,981,000)	(1,649,600)	70.8%
Total Charged to A&G O&M Expenses	\$5,775,500	\$ 8,975,000	\$3,199,500	55.4%

See Settlement Agreement, MECO T-11, Attachment 1 at 1 (Final Settlement), filed in Docket No. 2009-0163; Settlement Agreement, MECO T-12, Attachment 1 at 1 (Final Settlement), filed in Docket No. 2011-0092.⁶⁹

⁶⁸This pension amount is comprised of the NPPC and amortization of the regulatory pension asset via the pension tracking mechanism. The increase without the regulatory pension asset results in an increase of \$3,923,000 (2012 amount of \$7,978,000 - 2010 amount of \$4,055,000), or approximately 96.7% over the 2010 NPPC test year amount.

⁶⁹Although, the 55.40% increase in costs in two years (i.e., from 2010 to 2012) in and of itself is significant, the commission notes that the percentage increase would have been larger but for the increase in the employee benefits transfer factor (benefits transferred to capital projects) which increased from 24.00% to 30.30%, as stipulated to by the Parties. See Settlement Agreement, Exhibit 1 at 72.

The commission is particularly concerned that pension expense increased by \$4,594,000 (or approximately 105%) from the 2010 to 2012 test years (\$4,375,000 to \$8,969,000, respectively). Requiring ratepayers to absorb this level of increase over a short two-year period is unreasonable, given that the large increase in pension costs may be linked to MECO's decision to not explore alternatives to its current non-contributory defined benefit plans. In response to commission inquiry on whether MECO considered an alternative form of pension including requiring employees to contribute a percentage of their salaries towards their own retirement, or moving all their employees to a defined contribution plan to avoid passing on to its ratepayers the entire increase in costs for MECO's chosen form of retirement for its employees, MECO responded as follows:

No, MECO has not considered alternatives to avoid passing on to MECO ratepayers the entire increase in the cost to fund a non-contributory defined benefit retirement plan. However, traditionally, pensions are considered a reasonable cost of doing business for a utility company. For instance, reasonable expenses incurred in maintaining a pension plan for utility employees benefit the utility, its employees and the public, and therefore constitute legitimate operating expenses. . . . Amounts contributed to a pension fund are recoverable as long as the payments are reasonable and the plan provides for no more than a proper discretionary control to be exercised by the utility over the pension system.

. . . .

MECO has not considered requiring employees to contribute a percentage of their salary to the defined benefit retirement plan.

MECO's response to PUC-IR-8 at 1.

The commission agrees with MECO that pension costs are traditionally considered reasonable costs of doing business and are normally recoverable; however, the central issue is whether it is reasonable for ratepayers to absorb the full amount of the increase in pension costs if MECO fails to explore alternatives to its existing plans in an effort to decrease or limit the growth in costs.⁷⁰ Moreover, due to the use of the tracking mechanism it does not appear that MECO (and its parent companies) have a vested interest with respect to limiting the growth in pension costs.⁷¹ These are issues that need to be

⁷⁰The commission is aware that MECO changed the structure of its defined benefit plans for employees hired after May 1, 2011, "in an effort to control costs" by "lowering the multiplier used to calculate the pension benefit, reducing subsidies related to early retirement, raising the ages of eligibility for retirement benefits and eliminating automatic cost of living increases." MECO ST-12A at 2. However, these cost containment efforts appear to have no effect for the 2012 Test Year or any effect in the near-term given that MECO anticipates NPPC to increase to \$10,600,000 in 2013. See MECO ST-2A at 26.

⁷¹During an April 2013 interview published in EnergyBiz, when questioned whether unfunded pension obligations are a major problem for the electric industry, an HEI executive responded that the pension tracking mechanism largely immunizes the HECO Companies from an income standpoint and stated that when these benefits are paid they get it back in electric rates over time. See Martin Rosenberg, Unprecedented Spending Ahead, says Hawaii Exec, EnergyBiz, April 22, 2013.

investigated in depth prior to or during the next round of HECO Companies rate case proceedings.

Due to these concerns, the commission required MECO to update its accounts and provide a response to demonstrate the likely effects of a commission decision to revise the calculation of pension costs for the 2012 Test Year by utilizing a simple average of the 2012, 2011, and 2010 NPPC accruals as set forth in the docket record (with a similar revision for OPEB costs); and a commission discontinuation of the use of the pension and OPEB tracking mechanisms.⁷² By its IR, the commission clarified that under the revised calculation, pension costs for the 2012 Test Year would be \$6,132,000, which would result in an \$1,846,000 downward adjustment to the Parties' stipulated pension cost amount of \$7,978,000 (NPPC amount excluding the amortization of the regulatory pension assets).⁷³

In response, MECO states that the commission's proposed revised calculation of pension costs for the 2012 Test Year would be an intentional understatement of MECO's NPPC by \$1,846,000 and that such treatment of pension expense would not be appropriate, particularly if the pension and OPEB tracking

⁷²See PUC-IR-7 issued to MECO on November 14, 2012.

⁷³See id.

mechanisms are discontinued.⁷⁴ MECO provided supplemental testimony expressing its concerns about the possible discontinuation of the pension and OPEB tracking mechanisms on November 30, 2012, and requested a hearing regarding the mechanisms if the commission were to eliminate the mechanisms.⁷⁵

MECO states that the pension and OPEB tracking mechanisms provide for the recovery of pension and OPEB costs over time.⁷⁶ According to MECO, the tracking mechanisms fairly and accurately balance the interests of ratepayers with those of MECO and its investors "[b]y preventing the over- or under-recovery of pension and OPEB costs[.]"⁷⁷ MECO argues that the "reconciliation mechanism in the trackers ensures that neither ratepayers nor the utility will unnecessarily gain (or lose) to the detriment (or benefit) of the other party."⁷⁸ MECO asserts that elimination of the pension and OPEB tracking mechanisms would have severe consequences for all of the HECO Companies.⁷⁹ In sum, MECO states that elimination of the

⁷⁴See MECO's response to PUC-IR-7 at 3.

⁷⁵See MECO ST-2A at 4.

⁷⁶See id. at 2.

⁷⁷Id.

⁷⁸Id.

⁷⁹Id.

tracking mechanisms would be unfair to the Company, its shareholders, and its customers; cause recovery of pension and OPEB costs to be uncertain; and would require MECO to issue additional equity to maintain their equity ratios to adhere to generally accepted accounting principles.⁸⁰ MECO also asserts that elimination of the "pension and OPEB tracking mechanisms, particularly at a time when pension costs are known to be increasing, would substantially increase the likelihood of another downgrade of the Companies' credit rating, which would place them in the non-investment grade category."⁸¹ MECO provides supplemental testimonies as MECO ST-2A, MECO ST-11, MECO ST-12A, and MECO ST-20 all in opposition to the elimination of the tracking mechanisms.

As a concession, stating that it is sensitive to the burdens that any increase would have on its customers, MECO proposes that the commission allow the pension and OPEB tracking mechanisms to continue while also incorporating a test year estimate for NPPC for the 2012 Test Year that is lower than the amount stipulated to by the Parties in their Settlement Agreement.⁸² MECO states that using a three-year average of NPPC

⁸⁰See id. at 3-4.

⁸¹Id. at 4.

⁸²See id. at 29.

for 2010-2012, as initially proposed by the commission in PUC-IR-7, is a viable option.⁸³

Based on the foregoing, the commission finds it reasonable and in the public interest to recalculate pension costs for the 2012 Test Year by taking the three-year simple average of 2010, 2011, and 2012 NPPC accruals and, for consistency, to apply the same calculation for OPEB costs for the 2012 Test Year, resulting in revised pension and OPEB costs of \$6,132,000 and \$544,000, respectively. These adjustments result in a \$1,262,000 net downward adjustment to the Parties' stipulated A&G O&M expenses. As stated above, this and other issues may be investigated in depth during MECO's next rate case proceeding. Thus, in sum, the commission finds reasonable A&G O&M expenses of \$15,262,000 at present rates for the 2012 Test Year.

It is presumptuous and unreasonable for MECO and the other HECO Companies to assume they may have a blank check with regard to employee benefit expenses by expecting customers to pay for all cost increases, as was suggested in recent public comments by a HEI executive. The commission expects MECO, and other HECO Companies, to aggressively pursue every effort to

⁸³See id.

control and reduce employee benefit costs, not just defer cost increases for future recovery under the tracking mechanisms.

In addition, based on the record established in this proceeding, the commission will allow the pension and OPEB tracking mechanisms to continue in their present forms, at this time. However, as noted above, the appropriate level of increasing pension costs that ratepayers should bear if MECO continues to fail to explore alternatives to existing pension plans to decrease or limit the growth in costs will be reviewed in depth prior to or during the next round of HECO Companies' rate case proceedings. The current tracking mechanisms do not appear to provide any economic incentive to control pension and OPEB expenses. However, the extent to which the HECO Companies actively pursue employee benefit cost controls and reductions would inform the commission's perspective on these matters.

iii)

Future Study Costs

For the 2012 Test Year, MECO initially included a total normalized test year estimate of \$4,486,000 related to costs for future studies and IRP non-labor expenses.⁸⁴ In sum, MECO included normalized estimated costs for: (1) five production

⁸⁴See Settlement Agreement, Exhibit 1 at 7.

operational studies; (2) the Waena competitive bidding request for proposal ("RFPs"); (3) the Waena self-build option ("SBO"); (4) four studies related to integration of renewable energy resources; (5) nine transmission and distribution ("T&D") studies (collectively, "Future Studies"); and (6) IRP non-labor expenses.⁸⁵ The normalized O&M expenses and MECO's justifications for these Future Studies and IRP non-labor expenses are detailed in various O&M account (i.e., production, transmission and distribution, customer service, and A&G) discussions.

In its review of MECO's planned Future Studies, the Consumer Advocate characterizes them as "discrete and expensive" future study efforts.⁸⁶ According to the Consumer Advocate, "[i]n many instances, these are study efforts that MECO expects to extend over several years that have uncertain schedules and budgets and for which there is no contract or other firm commitment to actually conduct the study and incur the cost."⁸⁷ The Consumer Advocate proposes to reduce the overall 2012 Test

⁸⁵See id. at 5-7.

⁸⁶CA-T-2 at 52.

⁸⁷Id.

Year expenses for these study efforts by 25%.⁸⁸ In support of its recommendation, the Consumer Advocate states the following:

The incremental costs being proposed by MECO for the many special studies listed on C-2 are speculative estimated amounts for work that could extend over many future years, where the scope of planned efforts and range of expected costs is highly uncertain. These amounts should not be accepted by the Commission and imposed upon ratepayers without insertion of some budgetary constraints. Most of the listed special study efforts have either not commenced or are just starting up, such that work scope and budget amounts have not been well refined or documented. There is little evidence supporting most of the proposed cost amounts, as explained below, and tremendous uncertainty surrounding completion of the efforts at the estimated cost levels.

Rather than accepting all of the amounts proposed by MECO or attempting to independently scope and estimate alternative amounts, the Consumer Advocate recommends approval of a reduced overall provision for a portfolio of future studies that may ultimately be needed and undertaken by the Company, so as to encourage careful resource allocation and cost control in this area. In my judgment, advance ratepayer funding at 75 percent of MECO's estimated costs across all of the planned initiatives should provide substantial resources for the completion of a prioritized majority of the planned work, particularly if utility management is able to exercise cost control in soliciting and awarding contracts for this work.

CA-T-2 at 53-54 (emphasis in original).

⁸⁸See id.

In its rebuttal testimony, MECO disagreed with the Consumer Advocate's proposal arguing, among other things, that MECO already exercises cost controls when soliciting and awarding contracts.⁸⁹ Ultimately, for the purpose of reaching a global settlement, the Parties agreed to include \$3,562,000 for the various "studies" and IRP non-labor expenses as summarized on pages 6 and 7 of Exhibit 1 of the Settlement Agreement.⁹⁰ Basically, aside from the operational flexibility study,⁹¹ MECO

⁸⁹In addition, certain adjustments were made with respect to MECO's direct testimony position regarding its normalized 2012 Test Year expenses for future studies. For instance, the normalized test year estimate for the proposed biofuel storage study was reduced to \$0 given MECO's confirmation in its response to CA-IR-55 that the biofuel study will be included as part of MECO's fuels master plan, which is likely to result in a capital project. See Settlement Agreement, Exhibit 1 at 26. Moreover, based on new information related to its communications system study, MECO included an additional normalized cost of \$349,000 in its 2012 T&D test year estimate for future studies for the telecom master plan. See Settlement Agreement, Exhibit 1 at 36-37. MECO provides details regarding the telecom master plan in MECO RT-8.

⁹⁰See also Settlement Agreement, Exhibit 1 at 26-28; 36-38; 51-52; and 61.

⁹¹For the operational flexibility study, the Parties agreed to remove the \$22,625 contingency and miscellaneous expenses allowance from the total contract amount of \$384,607, gross up that amount to include general excise tax of 4.167%, and normalized the amount over three years, for a normalized 2012 Test Year estimate of \$126,000. According to the Parties, "[t]he rationale for not reducing the test year estimate for the operational flexibility study is (1) MECO has issued and signed a work authorization (i.e., purchase order, which, in conjunction with the vendor's proposal, forms a contract), for the test year estimate (before normalization) (CA-IR-487, Attachment A), (2) the vendor has started work on this study,

accepted the Consumer Advocate's proposed 25% reduction of the normalized costs for each of the Future Studies.

Here, the commission finds MECO's estimated normalized 2012 Test Year costs for the Future Studies to be excessive especially since there appears to be much uncertainty regarding the scope of work and actual costs regarding many of the Future Studies.⁹² As the Consumer Advocate notes, MECO's estimate for Future Studies are "speculative estimated amounts for work that could extend over many future years, where the scope of planned efforts and range of expected costs is highly uncertain."⁹³ The Consumer Advocate further notes that: (1) much of MECO's Future Study efforts have either not commenced, or are just starting up; (2) the scope of work and budget amounts for the Future Studies have not been well refined or documented; (3) there is little evidence supporting most of the proposed cost amounts; and (4) there is tremendous uncertainty surrounding the completion of the Future Study efforts at the estimated cost levels.⁹⁴

and (3) the contingency and miscellaneous amount of \$22,625 have been removed." See Settlement Agreement, Exhibit 1 at 26-27.

⁹²See CA-T-2 at 55-66 and CA-T-1 at 108-116.

⁹³CA-T-2 at 53.

⁹⁴See id.

The Consumer Advocate asserts that the commission should not accept MECO's estimated amounts and impose them on ratepayers without insertion of budgetary constraints.⁹⁵ The commission agrees. However, rather than estimating the normalized costs of Future Studies to be 75% of MECO's estimate, as proposed by the Consumer Advocate and largely accepted by MECO, the commission believes that 50% ratepayer advance funding (of MECO's estimate) for Future Studies is a more equitable distribution of these uncertain costs, at this juncture. In addition, the commission is concerned that while a number of studies have already been completed regarding, for example, integration of wind energy, MECO appears to have not fully implemented study recommendations. This concern is discussed further in later sections of this Decision and Order. Finally, the commission strongly echoes the Consumer Advocate's suggestion that MECO needs to prioritize its future study efforts. The commission believes that this adjustment to MECO's normalized test year estimate will motivate MECO to prioritize its efforts and more fully utilize the study recommendations. To this end, similar to the Consumer Advocate, the commission will not dictate which of the over twenty future study efforts MECO should pursue, but instead emphasizes that MECO's decisions should benefit ratepayers in a cost-effective manner.

⁹⁵See id.

It is the commission's impression that there is a trend of increasing number of technical studies being either incorporated into rate increase requests or into separate accounting deferral requests. The commission is concerned about this apparent trend. While technical studies may be necessary, perpetually studying the same or similar issues has no value for ratepayers and should not be an excuse for failure to act when it is in the customers' interest to do so. It is reasonable to expect a disciplined cost-controlled, well-managed company would be able to find off-setting cost reductions when there is a need to perform technical studies. Finally, technical studies to examine integration of renewable energy should not be a distinguishing characteristic for special cost recovery consideration; this should be a normal part of the utility's responsibilities.

Based on the foregoing, the commission finds it reasonable to adjust MECO's normalized 2012 Test Year O&M expenses for Future Studies, as stipulated by the Parties, downward by \$980,000.⁹⁶ With this adjustment, the commission

⁹⁶This adjustment amount is derived by, first, removing \$676,000 for IRP non-labor expenses from the Parties' calculations since IRP non-labor expense is addressed in the appropriate section below, then, adjusting MECO's rebuttal testimony number, as revised, by multiplying it by 0.50; $(\$4,488,000 - \$676,000) \times 0.5$ resulting in \$1,906,000. The difference between the Parties stipulated estimate for Future

finds reasonable a normalized 2012 Test Year estimate of \$1,906,000 for Future Studies, which are summarized on pages 6 and 7 of Exhibit 1 of the Parties' Settlement Agreement.

iv)

IRP Expenses

On March 1, 2012, the commission initiated Docket No. 2012-0036 to commence the IRP cycle for the HECO Companies⁹⁷ to examine the IRP Report and Action Plans for the planning period 2013-2032 ("IRP 2013"), to be submitted to the commission, in compliance with the commission's *A Framework for Integrated Resource Planning, Revised March 14, 2011* ("Revised Framework").⁹⁸ Based on the Revised Framework,⁹⁹ the commission

Studies, as revised (i.e., \$3,562,000 - \$676,000) and \$1,906,000 is \$980,000.

⁹⁷See In re Public Utilities Commission, Order No. 30233 Initiating HECO Companies' Integrated Resource Planning Process, filed on March 1, 2012, in Docket No. 2012-0036 ("Order Initiating IRP").

⁹⁸See In re Public Utilities Commission, Decision and Order, issued on March 14, 2011, in Docket No. 2009-0108 ("IRP Framework D&O").

⁹⁹The Revised Framework incorporates the concept of scenario planning, and "to better ensure a timely and transparent process, the commission incorporated into the Revised Framework an Independent Entity ("IE") to facilitate the IRP process and verify that the process is conducted in a manner consistent with the Revised Framework." Order Initiating IRP at 3 (footnote omitted).

established the following specific procedural milestones for
Docket No. 2012-0036:

Milestone	Timing
1. Docket Opens	Day 1
2. Independent Entity selected by the commission	60 days from docket open
3. HECO Companies file IRP schedule with commission	90 days from docket opening
4. Deadline to apply to serve on Advisory Group	100 days from docket opening
5. Commission establishes the Advisory Group	120 days from docket opening
6. HECO Companies file IRP Report and Action Plan with commission	365 days from the establishment of the Advisory Group
7. HECO Companies publish in the newspaper a notice that they have filed the IRP Report and Action Plan with the Commission	7 days after filing IRP Report and Action Plan
8. Applications to intervene are due to the commission	20 days after publication by the HECO Companies
9. Commission renders a decision on the IRP Action Plan within 6 months, to the extent possible	180 days from the HECO Companies filing of the IRP Report and Action Plan

See Order Initiating IRP at 9-10.

Consistent with the established milestones: (1) the commission selected Carl Freedman of Haiku Design and Analysis to serve as the IE for the HECO Companies' IRP 2013 proceeding¹⁰⁰; (2) the HECO Companies established a detailed

¹⁰⁰See Commission letter addressed to Jeffrey T. Ono, Executive Director of the Division of Consumer Advocacy and Dean K. Matsuura, Manager of Regulatory Affairs of HECO dated May 1, 2012, issued in Docket No. 2012-0036 ("Commission IE Letter"). In that letter, the commission stated that the IE shall be responsible for providing unbiased oversight of the IRP process in a cost-effective and timely manner and that

schedule for their IRP 2013¹⁰¹; and (3) the commission, on June 29, 2012, issued an order establishing the HECO Companies' IRP 2013 Advisory Group ("IRPAG").¹⁰² Thus, pursuant to the milestones (and the Revised Framework), the HECO Companies are required to file their IRP Report and Action Plans by June 28, 2013 (i.e., 365 days from the establishment of the IRPAG).¹⁰³

Pursuant to the Revised Framework, the IE submits to the commission periodic reports that are filed in Docket No. 2012-0036 (e.g., quarterly and certification reports) to keep the commission abreast of the HECO Companies' progress in IRP 2013. The IE, in his First Quarterly Report on the Status and Evaluation of the HECO/MECO/HELCO IRP Process ("First Quarter Report"), filed on October 23, 2012, identified certain concerns and deficiencies in the HECO Companies' IRP 2013 planning process. For instance, the IE reported that: (1) the

Mr. Freedman "shall report directly to, take direction from, and be accountable to, the Commission." See Commission IE Letter at 2.

¹⁰¹See HECO Companies' letter to the commission dated May 30, 2012, transmitting their IRP 2013 Schedule as Exhibit 1 ("IRP 2013 Schedule").

¹⁰²See In re Public Utilities Commission, Order No. 30513 Establishing the Advisory Group for the HECO Companies' Integrated Resource Planning Process, filed on June 19, 2012, in Docket No. 2012-0036.

¹⁰³See Order Initiating IRP at 9. See also IRP 2013 Schedule at 2.

identification of objectives and metrics have not been finalized at the end of the first quarter¹⁰⁴; (2) "the identified metrics [in the latest drafts] are not sufficient, of themselves, to sufficiently and accurately characterize the attainment of the objectives"¹⁰⁵; and (3) the planning scenarios and forecasts have not been finalized.¹⁰⁶ Thus, progress for IRP 2013 appears delayed since based on the IRP 2013 Schedule the objectives and matrices were to be finalized in August 17, 2012, and scenarios and forecasts were to be finalized by October 12, 2012.¹⁰⁷

In his Certification of Phases I and II of the HECO/MECO/HELCO IRP Process report ("First Certification Report"), the IE reported more troubling concerns with the progress of IRP 2013 which leads the commission to believe that the HECO Companies may be unable to timely complete and submit their IRP Report and Action Plans, delaying the overall progress of this proceeding. Specifically, with respect to planning objectives, the IE notes that the "current statement of measures of achievement remain deficient."¹⁰⁸ With respect to resource

¹⁰⁴See First Quarter Report at 5.

¹⁰⁵Id.

¹⁰⁶See id. at 7.

¹⁰⁷See IRP 2013 Schedule at 1.

¹⁰⁸First Certification Report at 12.

options, the IE reports that the IRP process is not being conducted consistent with the provisions of the Revised Framework and that there are some clear procedural infractions.¹⁰⁹ In addition, it does not appear that the HECO Companies have been sufficiently responding to the concerns and issues raised by the IRPAG¹¹⁰ and the HECO Companies appear to be behind the schedule that they established. Finally, while the principal issues for IRP 2013 were identified early during Phase I of the process, it does not appear that appropriate progress have been achieved at this stage to address them. The IE's Second Quarterly Report filed on January 18, 2013, does not provide the commission with any reasonable comfort regarding the progress of the HECO Companies' IRP 2013 process.¹¹¹

With respect to IRP cost recovery, the Revised Framework states the following:

The utility shall be entitled to recover its integrated resource planning and implementation costs that are reasonably incurred as determined by the Commission. The utility shall record costs associated with its integrated resource planning process in separate accounts to allow

¹⁰⁹See id. at 13-16.

¹¹⁰See id. at 9-10.

¹¹¹See Second Quarterly Report on the Status of the HECO/MECO/HELCO IRP Process, filed on January 18, 2013, in Docket No. 2012-0036.

review of the actual costs incurred as compared to the forecasted costs presented in each rate case or other equivalent cost-recovery mechanism.

IRP Framework D&O, Exhibit 1 at 21 (Section IV.A, Cost Recovery) (emphasis added).

At this juncture, recovery of IRP related costs appear to be premature. The IRP process is currently on-going and the IE has raised significant concerns regarding the HECO Companies' efforts, some of which are discussed above. These concerns indicate that compliance with the Revised Framework is uncertain at this time. Moreover, as the Consumer Advocate remarked in this proceeding, MECO is likely to over-recover IRP costs if the amounts included in the 2012 Test Year are not actually incurred as planned.¹¹² Due to these concerns, the commission, at this time, cannot appropriately determine whether MECO's IRP normalized expenses for the 2012 Test Year have been reasonably incurred, as required by the Revised Framework. Thus, the commission finds it reasonable and prudent to include an \$806,000 downward adjustment to MECO's O&M expenses. This amount represents an elimination of MECO's 2012 Test Year normalized IRP labor and non-labor costs as stipulated to by the Parties.¹¹³ The appropriate level and method of cost recovery

¹¹²See CA-T-2 at 64.

¹¹³See Settlement Agreement, Exhibit 1 at 51; MECO-1005; MECO's response to CA-IR-80, Attachment 2 at 1.

for MECO's IRP expenses will be determined by the commission in Docket No. 2012-0036, consistent with the requirements of the Revised Framework.

b.

Total O&M Expenses

With respect to the remaining 2012 Test Year O&M expense determinations on, for example, fuel, purchased power, production, and transmission, the commission approves the Parties' agreed-upon terms in their Settlement Agreement, as revised and later supplemented, with the adjustments discussed above, as applicable, as reasonable and supported by the present record.

Based on the foregoing, the commission approves for the 2012 Test Year total O&M expenses of \$318,814,000 at present rates, which are detailed in the Results of Operation schedule attached to this Decision and Order.

2.

Expenses Other Than O&M Expenses

a.

Depreciation & Amortization

The National Association of Regulatory Utility Commissioners Uniform System of Accounts for Class A and B Electric Utilities defines depreciation as follows:

[Depreciation], as applied to the depreciable utility plant, means the loss in service value not restored by current maintenance, incurred in connection with the consumption or prospective retirement of utility plant in the course of service from causes which are known to be in current operation and against which the utility is not protected by insurance. Among the causes to be given consideration are wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in the demand and requirements of public authorities.

MECO T-14 at 2. Test year depreciation and amortization expense estimates were calculated by:

[F]irst determining the estimated test year depreciation accrual and then adjusting for (1) vehicle depreciation, (2) contribution in aid of construction amortization, (3) federal investment tax credit amortization, and (4) the amortization of net regulatory assets and liabilities related to Statement of Financial Accounting Standards ("SFAS") No. 109, Accounting for Income Taxes. Accumulated depreciation represents the cumulative total of annual depreciation and amortization accrual amounts, after adjustments for retired assets, including (1) estimated plant retirements, (2) estimated salvage value of plant retirements, (3) estimated cost of removal of plant retirements, and (4) estimated plant adjustment to reflect the

adoption of the Company's Commission-approved vintage amortization accounting.

Settlement Agreement, Exhibit 1 at 75.

Initially, MECO proposed a 2012 Test Year consolidated estimate for depreciation expense of \$19,849,000.¹¹⁴ Later, MECO revised its estimate to \$19,687,000 to reflect the recalculated amount of test year depreciation accrual on actual plant balances as of December 31, 2011, and to correct certain calculation errors.¹¹⁵ With respect to these errors, MECO explains as follows:

In the calculation of depreciation expense and accumulated depreciation in the direct testimony in this rate case proceeding, MECO inadvertently calculated depreciation expense for certain production plant accounts at the sub-prime account level but should have calculated depreciation expense for these accounts at the prime account level. As shown in MECO-RWP-1401, page 4, line 11, the result of this correction is a \$279,000 increase in 2012 test year depreciation expense (see MECO RT-14, pages 3-4) and a corresponding increase to accumulated depreciation, as shown at MECO-RWP-1401, page 2, line 2. In its rebuttal testimony, the Company made two other corrections to its depreciation accrual and accumulated depreciation totaling a reduction of \$43,000 (see MECO-RWP-1401, page 3, line 2) for (1) correction to the depreciation rate for Molokai Division vehicles; and (2) correction for the calculation for Molokai

¹¹⁴See MECO T-14 at 16. See also MECO-1401 and Settlement Agreement, Exhibit 1 at 75.

¹¹⁵See MECO RT-14 at 1-4. See also Settlement Agreement, Exhibit 1 at 75-76.

Division transmission plant. Consequently, accumulated depreciation increased by a net of \$236,000[.]

Settlement Agreement, Exhibit 1 at 76.

The Consumer Advocate accepted MECO's adjustments to this expense item, and the Parties stipulated to a net depreciation expense amount of \$19,687,000, on a consolidated basis, for the 2012 Test Year.¹¹⁶

Upon review, the commission finds reasonable the Parties' consolidated depreciation expense estimate of \$19,687,000 at present rates for the 2012 Test Year.

b.

Amortization of State Investment Tax Credits ("ITC")

According to MECO, "[u]namortized investment tax credits are tax credits which reduce tax payments in the years the credits originate, but for ratemaking purposes, the credits are amortized."¹¹⁷ MECO further explains that "the unamortized balance serves to reduce rate base and the annual amortization reduces income tax expense."¹¹⁸

¹¹⁶See Settlement Agreement, Exhibit 1 at 76. See also Stipulated Supplement, Exhibit 1 at 1.

¹¹⁷See MECO T-17 at 20.

¹¹⁸See MECO T-15 at 29.

For the 2012 Test Year, MECO proposed a normalized estimate for amortization of state tax credits of \$274,000.¹¹⁹ In its direct testimony, the Consumer Advocate recommended a \$2,000 downward adjustment to this tax-related item, resulting in credit estimate of \$272,000, to reflect the depreciation rates approved in Docket No. 2009-0286.¹²⁰ MECO agreed to accept the Consumer Advocate's adjustment, and the Parties agreed to an amortization of State ITC amount of \$272,000 for the 2012 Test Year

Based on the forgoing, the commission finds the Parties' estimate of \$272,000 for amortization of State ITC at present rates for the 2012 Test Year to be reasonable.

c.

Taxes Other Than Income Taxes ("TOTIT")

Taxes included in TOTIT relate either to payroll or utility revenues, and are (1) Federal Insurance Contribution Act and Medicare taxes; (2) Federal Unemployment tax; (3) State Unemployment tax; (4) State Public Service Company tax; (5) State Public Utility fee; and (6) County Public Utilities

¹¹⁹See MECO-1504 at 2. See also Settlement Agreement, Exhibit 1 at 77.

¹²⁰See Settlement Agreement, Exhibit 1 at 77.

Franchise tax.¹²¹ A summary of the Parties' calculation for TOTIT is set forth in their Revised Settlement Agreement.¹²² Through their stipulations, the Parties ultimately agree to TOTIT of \$38,519,000 at present rates and \$39,667,000 at proposed rates for the 2012 Test Year.¹²³

Upon review, the commission finds the methodology used by the Parties to calculate TOTIT to be generally consistent with how TOTIT was calculated in previous rate case proceedings. Thus, the commission finds the Parties' methodology to calculate TOTIT for this proceeding to be reasonable. However, due to the commission's adjustments to various O&M expenses, as discussed above, the commission finds TOTIT of \$38,520,000 and \$38,989,000, at present and approved rates, respectively, to be reasonable for the 2012 Test Year.

d.

Interest on Customer Deposits

Customer deposits are amounts MECO collects from customers as security for their electric service.¹²⁴ Such

¹²¹See MECO T-15 at 2.

¹²²See Revised Settlement Agreement, Exhibit 1A at 7-12.

¹²³See Stipulated Supplement, Exhibit 1 at 1.

¹²⁴See MECO T-9 at 24.

deposits are required in cases where an applicant for service cannot establish credit by any of the methods set forth in MECO Tariff Rule No. 5 (Establishment and Re-establishment of Credit).¹²⁵ "The customer deposit is held until the customer has established a record of twelve months of continuous prompt payments, has closed the account, or service has been terminated for nonpayment of the full deposit and/or electric bills."¹²⁶ In accord with its tariff, MECO pays 6.00% interest on its customer deposit.¹²⁷

The Consumer Advocate accepts MECO's consolidated estimate of \$280,000 for interest on customer deposits at present rates for the 2012 Test Year, which is an amount supported in MECO's direct testimony.¹²⁸ Specifically, MECO states that the "2012 test year estimate of interest on customer deposit was derived by multiplying the average customer deposits for the 2012 test year of \$4,649,000 by the 6% interest rate to arrive at the \$280,000 consolidated test year estimate for interest on customer deposits[.]"¹²⁹

¹²⁵See id. at 25.

¹²⁶Id.

¹²⁷See MECO T-9 at 26. See also MECO Tariff Rule No. 6.

¹²⁸See Settlement Agreement, Exhibit 1 at 85. See also Stipulated Supplement, Exhibit 1 at 1.

¹²⁹MECO T-9 at 27.

Here, the commission finds reasonable the Parties' estimate of \$280,000 for interest on customer deposits at present rates for the 2012 Test Year.

e.

Income Taxes

For the 2012 Test Year, MECO calculates test year income tax expense based on the "short form" method used by the commission in previous rate cases. "The short form method is used for ratemaking purposes and calculates the total income tax expense in one step, rather than calculating the current and deferred components of income tax expense separately."¹³⁰ This method, according to MECO, simplifies the calculation of income tax expense and is the methodology used to calculate income tax expense for ratemaking purposes by the HECO Companies.¹³¹

Initially, MECO calculated income tax expense for present and proposed rates utilizing a top composite rate of 39.16%, derived from the top marginal federal income tax rate of 35% and a state income tax rate of 6.4%.¹³² MECO asserted that the combined rate changed in 2011 (from 38.91%) due to the

¹³⁰See MECO T-15 at 9 (internal quotes omitted).

¹³¹See id.

¹³²See id.

change in the law under Act 97, SLH 2011, which no longer allows corporations the deduction for state income taxes in calculating Hawaii income tax liability. Later, in response to CA-IR-3, MECO "explained that the proper composite income tax rate to apply to taxable income for ratemaking purposes is again 38.91%, which accounts for the deductibility of the state income taxes for state income tax purposes as ruled by the State Department of Taxation in Announcement No. 2011-20."¹³³ The Consumer Advocate utilized the lower rate in its calculation.¹³⁴ During settlement negotiations, Parties officially stipulated to use the composite tax rate of 38.91% to calculate income tax expense for the 2012 Test Year. As a result, through the various stipulations, the Parties ultimately agreed on income tax expenses of \$9,353,000 at present rates and \$13,949,000 at proposed rates.¹³⁵

Upon review, the commission finds that the use of the "short form" method and the application of the composite tax rate of 38.91% are consistent with how the commission calculated income tax expense in previous rate case proceedings and, thus, the commission finds the Parties' methodology to calculate

¹³³See Settlement Agreement, Exhibit 1 at 81-82. See also MECO's response to CA-IR-3.

¹³⁴See CA-T-2 at 85-86.

¹³⁵See Stipulated Supplement, Exhibit 1 at 1.

income tax expense for this proceeding to be reasonable. However, due to the commission's adjustments to various O&M expenses, as discussed above, the commission finds income tax expense of \$10,629,000 and \$12,522,000, at present and approved rates, respectively, to be reasonable for the 2012 Test Year.

f.

Total Non-O&M Expenses

For the 2012 Test Year, the commission approves as reasonable total non-O&M expenses of \$68,844,000 at present rates, which are detailed in the Results of Operation schedule attached to this Decision and Order.

D.

Rate Base

Rate base is defined as the net investment that is used or useful for public utility purposes that has been funded by investors.¹³⁶ MECO calculates rate base as "an average rate base which is the sum of the average balances of investments in assets less the sum of the average balances of funds from non-investors, plus or minus the working cash[.]"¹³⁷

¹³⁶See MECO T-17 at 2.

¹³⁷Id.

For the 2012 Test Year, the Parties ultimately stipulate to an estimated consolidated average rate base as follows:¹³⁸

<u>Investment in Assets (additions)</u>	<u>Average Balance</u>
Net Cost of Plant in Service	\$479,541,000
Property Held for Future Use	1,303,000
Fuel Inventory	18,577,000
Materials & Supplies Inventories	13,387,000
Unamortized Net SFAS 109 ¹³⁹ Reg. Asset	8,524,000
Pension Regulatory Asset	3,915,000
OPEB Regulatory Asset	303,000
Contributions in Excess of NPPC Reg. Asset	5,751,000
Unamortized System Development Costs	<u>1,364,000</u>
Total Investments in Assets	\$532,663,000
 <u>Funds from Non-Investors (subtractions)</u>	
Unamortized CIAC ¹⁴⁰	\$ 79,294,000
Customer Advances	4,624,000
Customer Deposits	4,579,000
Accumulated Deferred Income Taxes	48,905,000
Unamortized Investment Tax Credits	<u>12,451,000</u>
Total Deductions	<u>\$149,852,000</u>
 Difference	\$382,811,000
 Working Cash at TY 2010 Final Rates	<u>\$ 10,852,000</u>
 Rate Base at TY 2010 Final Rates	\$393,663,000
 Change in Rate Base - Working Cash	(\$200,000)
 Average Rate Base at Proposed Rates	\$393,463,000

¹³⁸See Stipulated Supplement, Exhibit 1 at 3.

¹³⁹Here, "SFAS 109" refers to Statement of Financial Accounting Standards No. 109.

¹⁴⁰Here, "CIAC" refers to contributions-in-aid-of-construction.

Net Cost of Plant in Service

Net cost of plant in service is the gross plant in service less accumulated depreciation.¹⁴¹ This component of rate base represents MECO's unrecovered investments in plant necessary to provide electric service to its customers.¹⁴² The estimated average net cost of plant in service is the simple average of the estimated net cost of plant in service as of December 31, 2011 and 2012.¹⁴³

For the 2012 Test Year, the Parties agree to a total average consolidated net cost of plant in service of \$479,541,000.¹⁴⁴ This figure is a compromise amount and is based on MECO's direct testimony estimate of \$483,378,000¹⁴⁵ and certain adjustments, including: (1) the Consumer Advocate's proposal to incorporate actual balances as of December 31, 2011 (in place of the estimated year-end balances), and the effects

¹⁴¹See MECO T-17 at 6.

¹⁴²See id. at 7.

¹⁴³See id.

¹⁴⁴See Settlement Agreement, Exhibit 1 at 90. See also Stipulated Supplement, Exhibit 1 at 3.

¹⁴⁵See MECO-1701.

of changes to 2012 estimates¹⁴⁶; (2) MECO's rebuttal adjustments to reflect the deferral of the field manager handheld system and correction for on-cost clearing; (3) an upward adjustment to plant for increased employee benefits transferred to construction of \$576,000 to reflect the Consumer Advocate's proposal to reduce employee benefits expense in A&G O&M by \$793,000; and (4) adjustments to reflect revisions to MECO's depreciation calculations for certain accounts. The adjustments to MECO's direct testimony figure for net cost of plant in service, as enumerated above, are set forth in the record of this proceeding and summarized in the Parties' Settlement Agreement.¹⁴⁷

Based on the record and the Parties' overall settlement, the commission finds reasonable the Parties' estimated balance of \$479,541,000 (on a consolidated basis) for net plant in service for the 2012 Test Year.

¹⁴⁶See MECO's response to CA-IR-199; CA-T-1 23-24; Exhibit CA-101 Schedule B-1 at 1. See also Settlement Agreement, Exhibit 1 at 88-89.

¹⁴⁷See Settlement Agreement, Exhibit 1 at 89-90.

Property Held for Future Use

Property held for future use ("PHFU") is property owned by MECO and held for future utility purposes.¹⁴⁸ "PHFU represents the Company's investment in property needed to provide electric service in the future."¹⁴⁹

For the 2012 Test Year, the Parties stipulate to PHFU of \$1,303,000.¹⁵⁰ This amount represents approximately 49.47% of MECO's \$2,633,000 total investment for its Waena property, which is the portion of the property designated for the installation of generating facilities.¹⁵¹ The commission previously approved inclusion of this amount of PHFU in the MECO 2010 Rate Case.¹⁵²

Based on the foregoing, the commission accepts as reasonable the Parties' agreement of \$1,303,000 for total average consolidated PHFU for the 2012 Test Year.

¹⁴⁸See MECO T-17 at 7.

¹⁴⁹Id.

¹⁵⁰See Settlement Agreement, Exhibit 1 at 91. See also Stipulated Supplement, Exhibit 1 at 3.

¹⁵¹See MECO T-17 at 8.

¹⁵²See MECO 2010 Final at 68.

Fuel Inventory

Fuel inventory is MECO's investment in a supply of fuel held in inventory.¹⁵³ MECO states that it "requires an investment in fuel inventory to ensure a sufficient supply of fuel for its power plants in order to provide reliable electric service to its customers."¹⁵⁴

For the 2012 Test Year, the Parties agree to use a consolidated fuel inventory estimate of \$18,577,000.¹⁵⁵ This figure is a compromise position and is based on MECO's direct testimony estimate of \$18,593,000¹⁵⁶ (which is based on a 37-day IFO and a 30-day diesel fuel inventory) and a downward adjustment to recognize fuel savings regarding MECO's IFO inventory to account for the used lube oil consumed at KPP.¹⁵⁷

Based on the record and the Parties' overall settlement, the commission finds reasonable the Parties'

¹⁵³See MECO T-17 at 9.

¹⁵⁴Id.

¹⁵⁵See Settlement Agreement, Exhibit 1 at 91. See also Stipulated Supplement, Exhibit 1 at 3.

¹⁵⁶See MECO-604 at 1.

¹⁵⁷See CA-T-3 at 19-20; CA 101, Schedule B-3; MECO RT-6 at 6-7; and MECO-R-604.

agreement on a consolidated fuel inventory estimate of \$18,577,000 for MECO's 2012 Test Year.

4.

Materials & Supplies Inventories

Materials & supplies inventories consist of inventory for production, transmission and distribution, and lube oil.¹⁵⁸

"The materials and supplies inventory balances included in rate base consist of the test year average balances adjusted by the payment lag associated with materials and supplies purchases."¹⁵⁹

Initially, MECO estimated a consolidated average materials and supplies inventories balance of \$13,179,000 for the 2012 Test Year.¹⁶⁰ MECO later agreed to accept the Consumer Advocate's proposal to reflect the actual recorded balances as of December 31, 2011, and revised projected year-end 2012 balances.¹⁶¹ As a result, the Parties stipulate to a total

¹⁵⁸See MECO T-17 at 9.

¹⁵⁹Id.

¹⁶⁰See MECO-1705; MECO T-17 at 9-11.

¹⁶¹See CA-T-1 23-24; Exhibit CA-101 Schedule B-1 at 1; MECO RT-17 at 6; and MECO-R-1701. See also Settlement Agreement, Exhibit 1 at 88-89.

average consolidated materials and supplies inventories estimate of \$13,387,000.¹⁶²

Upon review, the commission finds the Parties' agreement on a total average consolidated materials and supplies inventories estimate for the 2012 Test Year of \$13,387,000 to be reasonable.

5.

Unamortized Net SFAS 109 Regulatory Asset

The asset known as the unamortized net SFAS 109 regulatory asset is an accounting asset created by the reporting requirements of SFAS 109.¹⁶³ With respect to SFAS 109, MECO explains as follows:

SFAS 109 requires the debt portion of [AFUDC], as well as any other item previously recorded on a net-of-tax basis, to be calculated and capitalized on a gross-of-tax basis. As a result, plant in service would have increased by the tax effect of the debt portion of AFUDC. However, instead of increasing plant in service, SFAS 109 requires this gross-up adjustment to a regulatory asset, with the offsetting credit to the deferred income tax liability account. Because the regulatory asset is offset by the corresponding increase in accumulated deferred income taxes, there is no net rate base impact.

MECO T-17 at 11 (emphasis in original)

¹⁶²See Settlement Agreement, Exhibit 1 at 92. See also Stipulated Supplement, Exhibit 1 at 3.

¹⁶³See MECO T-17 at 11.

For the 2012 Test Year, the Parties stipulate to an average unamortized net SFAC 109 regulatory asset balance of \$8,524,000.¹⁶⁴ This figure is based on MECO's direct testimony average balance for this regulatory asset of \$8,655,000,¹⁶⁵ adjusted downward by \$132,000 to reflect MECO's acceptance of the Consumer Advocate's recommendation to replace the estimated beginning balance with the actual December 31, 2011 balance for this rate base asset.¹⁶⁶

Based on the record and the Parties' overall settlement, the commission finds reasonable the Parties' agreement on an average unamortized net SFAS 109 regulatory asset balance of \$8,524,000 for the 2012 Test Year.

6.

Pension Regulatory Asset

The pension regulatory asset (aka pension tracking mechanism regulatory asset), established with the adoption of the pension tracking mechanism during MECO's 2007 test year rate case ("MECO 2007 Rate Case"), represents the actual cumulative

¹⁶⁴See Settlement Agreement, Exhibit 1 at 92. See also Stipulated Supplement, Exhibit 1 at 3.

¹⁶⁵See MECO T-15 at 20.

¹⁶⁶See CA-T-1 23-24; Exhibit CA-101 Schedule B-1 at 1; MECO RT-17 at 6; and MECO-R-1701. See also Settlement Agreement, Exhibit 1 at 88-89.

NPPC in excess of the cumulative NPPC included in rates during a rate effective period.¹⁶⁷ "The pension tracking mechanism calls for the recording of a pension regulatory asset (or regulatory liability) to track the cumulative difference between the level of actual NPPC during a rate effective period and the level of Commission approved NPPC included in rates for that same period."¹⁶⁸ MECO states that the "pension tracking mechanism ensures that the pension costs recovered through rates are based on NPPC as reported for financial reporting purposes and that all amounts contributed to the pension trust funds are in an amount equal to actual NPPC and recoverable through rates."¹⁶⁹

Initially, MECO proposed an average test year estimate of \$3,108,000 for pension regulatory asset to be included in rate base.¹⁷⁰ In its direct testimony, the Consumer Advocate proposed an average 2012 Test Year estimate for pension tracking mechanism regulatory asset of \$3,869,000.¹⁷¹ This estimate reflects the use of the recorded December 31, 2011 regulatory asset balance (rather than the estimated amount), updated cost

¹⁶⁷See MECO T-17 at 12.

¹⁶⁸Id.

¹⁶⁹Id.

¹⁷⁰See MECO-1135 at 2.

¹⁷¹See Exhibit CA-101, Schedule B-2 at 1.

information provided by MECO's actuary, Towers Watson in October 2011 (provided by MECO in response to CA-IR-421), and an adjustment to reflect the impact of revising 2012 NPPC forecast upward and commencing the amortization with the expected interim effective date on or about May 22, 2012 (rounded to June 1, 2012 for calculation purposes).¹⁷² Later, in its rebuttal testimony, MECO proposed an average test year estimate for pension tracking mechanism regulatory asset of \$3,915,000. This figure incorporates the recorded regulatory asset balance as of December 31, 2011, the latest information provided by MECO's actuary in February 2012 for the 2012 NPPC, and adjustments to reflect the impact of revising the 2012 NPPC forecast upward and commencing the change in regulatory asset amortization to coincide with a June 1, 2012 effective date.¹⁷³ During settlement, the Parties agreed to the continuation of the pension tracking mechanism and the inclusion of \$3,915,000 for pension regulatory asset in rate base, which reflects MECO's most current NPPC information.¹⁷⁴

¹⁷²See CA-T at 27-35; Exhibit CA-101, Schedule B-2 at 1; and Settlement Agreement, Exhibit 1 at 88-89. See also Settlement Agreement, Exhibit 1 at 93.

¹⁷³See MECO RT-11 at 9-12; and MECO-R-1135 at 2 and 5. See also Settlement Agreement, Exhibit 1 at 94.

¹⁷⁴See Settlement Agreement, Exhibit 1 at 95. See also Stipulated Supplement, Exhibit 1 at 3.

While the commission is concerned regarding the increasing cost of MECO's pension in general, which is detailed in the pension expense discussion above, based on the record and the Parties' overall settlement, the commission will allow the pension tracking mechanism to continue at this juncture, and finds reasonable the Parties' agreement to include in rate base a 2012 Test Year average balance for pension tracking mechanism regulatory asset of \$3,915,000. However, the commission reiterates that it will investigate the need for and the unintended consequences of maintaining the pension tracking mechanism prior to or during the next round of HECO Companies' rate case proceedings. A reevaluation of the pension tracking mechanism is necessary since MECO appears to have failed to appreciate the need to explore alternatives to its current pension plans in an effort to decrease or limit the growth in pension costs, and due to a perception that the tracking mechanism "immunizes" the Company from raising costs, as recently articulated by a HEI executive.¹⁷⁵

¹⁷⁵See Supra at 40, n.71.

OPEB Regulatory Asset

The post-retirement benefits other than pension (or OPEB) regulatory asset (aka OPEB tracking mechanism regulatory asset), established upon the adoption of the OPEB tracking mechanism during the MECO 2007 Rate Case, represents the actual cumulative OPEB costs during a rate effective period in excess of the cumulative OPEB costs included in rates during that same period.¹⁷⁶ According to MECO, this mechanism ensures that OPEB costs recovered through rates are based on the NPBC "as reported for financial reporting purposes and that all amounts contributed to the OPEB trust funds are in an amount equal to the actual OPEB costs and are recoverable through rates."¹⁷⁷

At the outset, MECO proposed to include in the 2012 Test Year rate base an average OPEB tracking mechanism regulatory asset of \$310,000.¹⁷⁸ In its direct testimony, the Consumer Advocate proposed an average 2012 Test Year estimate for OPEB tracking mechanism regulatory asset of \$321,000, which incorporated the recorded December 31, 2011 regulatory asset balance (as opposed to an estimated balance), updated cost

¹⁷⁶See MECO T-17 at 13-14.

¹⁷⁷Id. at 14.

¹⁷⁸See MECO-1136 at 3.

information provided by MECO's actuary, Towers Watson, in October 2011 (provided by MECO in response to CA-IR-421), and an adjustment to reflect the impact of revising 2012 NPBC forecast upward and commencing the amortization with the expected interim effective date on or about May 22, 2012 (rounded to June 1, 2012 for calculation purposes).¹⁷⁹ In its rebuttal testimony, MECO proposed an average 2012 Test Year estimate for OPEB tracking mechanism regulatory asset of \$303,000. MECO's rebuttal average estimate incorporates the recorded regulatory asset balance as of December 31, 2011, the latest information provided by MECO's actuary in February 2012 for 2012 NPBC, and adjustments to reflect the impact of revising the 2012 NPBC forecast upward and commencing the change in regulatory asset amortization to coincide with a June 1, 2012 effective date.¹⁸⁰ During settlement, the Parties agreed to the continuation of the OPEB tracking mechanism and the inclusion of \$303,000 for OPEB regulatory asset in rate base, which reflects MECO's most updated NPBC information.¹⁸¹

¹⁷⁹See CA-T at 27-35; Exhibit CA-101, Schedule B-2 at 1; and Settlement Agreement, Exhibit 1 at 88-89. See also Settlement Agreement, Exhibit 1 at 93.

¹⁸⁰See MECO RT-11 at 15-18; and MECO-R-1136 at 2 and 5. See also Settlement Agreement, Exhibit 1 at 94.

¹⁸¹See Settlement Agreement, Exhibit 1 at 95. See also Stipulated Supplement, Exhibit 1 at 3.

Based on the foregoing, the commission will allow the continuation of the OPEB tracking mechanism at this juncture, and the finds reasonable the inclusion in rate base of a 2012 Test Year average balance for OPEB tracking mechanism regulatory asset of \$303,000, as agreed to by the Parties. Nonetheless, as previously stated by the commission, the commission intends to investigate the need for and the unintended consequences of maintaining the OPEB tracking mechanism prior to or during the next round of HECO Companies' rate case proceedings. The commission is very troubled with the perception that the tracking mechanisms "immunizes" the Company from rising employee benefits costs.¹⁸²

8.

Contributions in Excess of NPPC Regulatory Asset

Contributions in excess of NPPC are cumulative amounts of MECO's contributions to the pension trust made in excess of the cumulative pension cost (NPPC accruals).¹⁸³ Under the pension tracking mechanism, until the pension asset is reduced to zero, MECO is required to fund the minimum required level

¹⁸²See Supra at 40, n.71.

¹⁸³See T-17 at 16-17.

under the law.¹⁸⁴ Specifically, MECO's contribution amount is calculated by its actuary, Towers Watson, in accordance with the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code.¹⁸⁵

According to MECO, its direct testimony rate base calculation did not include an amount for contributions in excess of the NPPC regulatory asset balance since it had expected to make contributions in 2012 in amounts equal to the actuarially calculated 2012 NPPC levels.¹⁸⁶ However, MECO states that updated information was received indicating "that test year estimates for MECO's 2011 and 2012 minimum required pension contributions should be increased by \$3,101,000 and \$2,474,000, respectively, such that the estimated average pension contributions in excess of NPPC would be \$4,338,000 in accordance with the pension tracking mechanism."¹⁸⁷

In its direct testimony, the Consumer Advocate proposed a 2012 Test Year estimate for average contributions in excess of NPPC regulatory asset of \$6,035,000.¹⁸⁸ This figure is based on

¹⁸⁴See MECO T-11 at 96.

¹⁸⁵See T-17 at 17.

¹⁸⁶See Settlement Agreement, Exhibit 1 at 95.

¹⁸⁷See MECO T-11 at 97. See also Settlement Agreement, Exhibit 1 at 95.

¹⁸⁸See Settlement Agreement, Exhibit 1 at 95.

updated information provided by MECO's actuary in October 2011 (provided by MECO in response to CA-IR-421). In its decision to include updated figures in the 2012 Test Year rate base, the Consumer Advocate stated the following:

[T]he pension (and OPEB) tracking mechanism was intended to result in actual NPPC (and NPBC) being included in rates over time. Rather than rates based solely and automatically on the NPPC (or NPBC) forecast for a particular rate case test year, the tracking mechanisms were designed with the intent of balancing the interests of the ratepayers and the Company. Because of how the mechanisms work, the process is not designed to create winners and losers - whether to include the updated NPPC (or NPBC) in rates now or later is merely a matter of cash flow from the perspective of both the Company and its ratepayers.

CA-T-1 at 32 (emphasis in original). Among other things, the Consumer Advocate also noted that "the recent updates to the 2012 NPPC and NPBC forecasts are primarily due to a reduction in the discount rate, decrease in the expected rate of return, and an increase in the unrecognized losses subject to amortization."¹⁸⁹

Later, based on the latest information provided by MECO's actuary in February 2012 for the 2012 NPPC and contributions, MECO proposed a 2012 Test Year estimate for average contributions in excess of NPPC regulatory asset of \$5,751,000. During settlement, the Parties agreed to include in

¹⁸⁹CA-T-1 at 33.

rate base an average 2012 Test Year balance for contributions in excess of NPPC regulatory asset of \$5,751,000.¹⁹⁰

Given the foregoing and the Parties' overall settlement, the commission finds reasonable the Parties' agreement to include a balance for contributions in excess of NPPC regulatory asset of \$5,751,000 in rate base for the 2012 Test Year.

9.

Unamortized System Development Costs

For the 2012 Test Year, MECO initially proposed to include in rate base a consolidated unamortized system development cost balance of \$4,805,000; consisting of \$1,177,000 for the Human Resource Management System project ("HR Suites"), \$3,441,000 for the CIS project, and \$187,000 for the Budget System Replacement ("Budget System") project.¹⁹¹ According to MECO the "unamortized costs of computer software development projects are similar to the undepreciated costs of capitalized

¹⁹⁰See Settlement Agreement, Exhibit 1 at 95. See also Stipulated Supplement, Exhibit 1 at 3.

¹⁹¹See MECO 1132 at 1. See also Settlement Agreement, Exhibit 1 at 95.

plant and equipment, and should be included in the calculation of rate base."¹⁹²

The Consumer Advocate recommended the elimination of the rate base impact of the CIS project pending the regulatory audit ordered in the HECO 2009 Rate Case,¹⁹³ and proposed an unamortized system development cost estimate of \$1,364,000 for this item, which represents costs related to the HR Suites¹⁹⁴ and Budget System¹⁹⁵ projects. Ultimately, based their stipulation with respect to CIS project costs,¹⁹⁶ MECO accepted the Consumer Advocate's position, and the Parties agreed to include in rate

¹⁹²MECO T-17 at 16.

¹⁹³See CA-T-2 at 72; Exhibit CA-102, Schedule B-4.

¹⁹⁴In the MECO 2010 Rate Case, the commission allowed the inclusion of \$1,341,300 for unamortized system development costs for the HR Suites project in MECO's rate base. See MECO 2010 Final at 75.

¹⁹⁵In November 2011, the commission approved the HECO Companies' request to expend \$3.1 million for the Budget System project; provided that no part of the project may be included in their respective rate base unless and until the project is in fact installed and use and useful for public utility purposes, and approved their proposed accounting treatment to defer costs related to the computer software development, subject to certain limitations. See In re Hawaiian Electric Company, Inc., Hawaii Electric Light Company, Inc., Maui Electric Company, Inc., Decision and Order filed on November 2, 2011 in Docket No.2010-0339.

¹⁹⁶See Settlement Agreement, Exhibit 1 at 3-5. See also Parties' Audit Stipulation filed on January 28, 2013, in HECO 2009 Rate Case.

base an average 2012 Test Year balance for unamortized system development costs of \$1,364,000.¹⁹⁷

Based on the foregoing, the commission accepts as reasonable the Parties' agreement to include in rate base a consolidated average 2012 Test Year balance of \$1,364,000 for unamortized system development costs.

10.

Unamortized CIAC

CIAC is money or property that a developer or customer contributes to MECO to fund a utility capital project.¹⁹⁸ CIAC is nonrefundable, as set forth in MECO's tariff, and "[a]mortization of CIAC offsets depreciation expense."¹⁹⁹

MECO initially proposed to include in rate base a 2012 Test Year consolidated average unamortized CIAC balance of \$81,447,000.²⁰⁰ Later, in response to the Consumer Advocate's proposal, MECO agreed to update the relevant balances to reflect the actual recorded unamortized CIAC balance as of December 31,

¹⁹⁷See Settlement Agreement, Exhibit 1 at 96. See also Stipulated Supplement, Exhibit 1 at 3.

¹⁹⁸See MECO T-17 at 18.

¹⁹⁹Id.

²⁰⁰See MECO-1706 at 1.

2011, and revised projected year-end 2012 balance.²⁰¹ As a result, the Parties stipulate to a total average 2012 Test Year consolidated unamortized CIAC balance of \$79,294,000.²⁰²

Upon review, commission finds reasonable the Parties' agreement to reflect in rate base \$79,294,000 for total average consolidated unamortized CIAC for the 2012 Test Year.

11.

Customer Advances

Customer advances for construction are funds paid by customers to MECO which may be refunded in whole or in part as set forth in MECO's tariff.²⁰³

In its direct testimony, MECO proposed a 2012 Test Year average customer advances on a consolidated basis of \$4,663,000.²⁰⁴ Later, in response to the Consumer Advocate's proposal, MECO agreed to update the relevant balances to reflect the actual recorded customer advances balance as of December 31, 2011 and revised projected year-end 2012 balance for this rate

²⁰¹See MECO RT-17 at 6-7; MECO-R-1706 at 1; and Settlement Agreement, Exhibit 1 at 88-89.

²⁰²See Settlement Agreement, Exhibit 1 at 97. See also Stipulated Supplement, Exhibit 1 at 3.

²⁰³See MECO T-17 at 18.

²⁰⁴See Settlement Agreement, Exhibit 1 at 97.

base item.²⁰⁵ Consequently, the Parties stipulate to a total average 2012 Test Year consolidated customer advances of \$4,624,000.²⁰⁶

Based on the foregoing, the commission finds the Parties' agreement to reflect \$4,624,000 for customer advances on a consolidated basis in rate base for the 2012 Test Year to be reasonable.

12.

Customer Deposits

Customer deposits are funds collected from customers who do not meet MECO's criteria for establishing credit at the time the customer requests service.²⁰⁷

At the outset, MECO proposed a 2012 Test Year average customer deposits on a consolidated basis of \$4,649,000.²⁰⁸ In response to the Consumer Advocate's recommendation, MECO agreed to adjust its customer deposit balances to reflect the actual recorded customer deposits balance as of December 31, 2011, and

²⁰⁵See MECO RT-16 at 5-6; MECO-R-1606 at 1; and Settlement Agreement, Exhibit 1 at 88-89.

²⁰⁶See Settlement Agreement, Exhibit 1 at 97. See also Stipulated Supplement, Exhibit 1 at 3.

²⁰⁷See MECO-T-17 at 19.

²⁰⁸See MECO T-9 at 24 and MECO-913 at 1.

revised projected 2012 year-end balance.²⁰⁹ As a result, the Parties stipulate to an average 2012 Test Year consolidated customer deposits amount of \$4,579,000.²¹⁰

The commission finds the Parties' estimated balance of \$4,579,000 for customer deposits on a consolidated basis for the 2012 Test Year to be reasonable.

13.

Accumulated Deferred Income Taxes

Accumulated deferred income taxes (or ADIT), which are provided by ratepayers, represents the cumulative amount by which tax expense has exceeded tax remittances.²¹¹

MECO initially proposed an ADIT credit balance of \$48,371,000 for the 2012 Test Year.²¹² Upon negotiations with the Consumer Advocate,²¹³ the Parties initially stipulated to reflect an average ADIT credit balance of \$48,931,000 for the

²⁰⁹See MECO T-9 at 10; MECO-R-909 at 1; and Settlement Agreement, Exhibit 1 at 88-89.

²¹⁰See Settlement Agreement, Exhibit 1 at 98. See also Stipulated Supplement, Exhibit 1 at 3.

²¹¹See MECO T-17 at 19-20.

²¹²See MECO T-15 at 30 and MECO-1505 at 6.

²¹³See Settlement Agreement, Exhibit 1 at 98-99; and MECO T-15, Attachment 2 at 1-3.

2012 Test Year.²¹⁴ Subsequently, the Parties revised their stipulated ADIT balance to reflect the incorporation of actual regulatory commission expenses and the removal of the allocated expenses for non-incentive compensation and related expenses related to HEI as set forth in their Stipulated Supplement.²¹⁵ With these changes, the Parties ultimately stipulate to an ADIT balance for the 2012 Test Year of \$48,905,000.²¹⁶

Based on the Parties' stipulations, the commission finds reasonable the Parties' agreement on a 2012 Test Year ADIT consolidated credit balance of \$48,905,000.

14.

Unamortized Investment Tax Credits

Unamortized investment tax credits ("ITC") are tax credits, funded by ratepayers, that reduce tax payments in the years the credits originate, but for ratemaking purposes, the credits are amortized.²¹⁷ According to MECO the entire balance

²¹⁴See Settlement Agreement, Exhibit 1 at 100.

²¹⁵See Stipulated Supplement at 1.

²¹⁶See id., Exhibit 1 at 3.

²¹⁷See MECO T-17 at 20.

is made up of state ITC, since the applicable federal ITC was fully amortized as of December 31, 1999.²¹⁸

MECO, in its direct testimony, proposed to include in rate base a 2012 Test Year estimate of average unamortized state ITC of \$12,482,000.²¹⁹ The Consumer Advocate proposed a \$10,000 adjustment upward, resulting an average credit balance of \$12,492,000²²⁰ which reflects: (1) the use of recorded December 31, 2011 balance as opposed to an estimated balance, (2) the amortization of state tax credits for depreciation rates approved in Docket No. 2009-0286, and (3) an adjustment to correct plant additions in the state tax calculations (based on MECO-WP-1601B and MECO's response to CA-IR-276).²²¹ In its rebuttal testimony, MECO revised its 2012 Test Year ITC average balance to \$12,451,000.²²² This amount is derived by accepting all of the adjustments proposed by the Consumer Advocate and includes an additional adjustment to reflect tax credit

²¹⁸See MECO T-15 at 28. According to MECO, "[f]ederal investment credits originating after 1971 are subject to the tax normalization rules under the 1971 Revenue Act and are not included as a reduction in rate base under" Internal Revenue Code § 46. MECO T-15 at 28.

²¹⁹See id. at 28. See also MECO-1504 at 1-2.

²²⁰See Exhibit CA-101, Schedule B-1 at 1.

²²¹See Settlement Agreement, Exhibit 1 at 100.

²²²See MECO-R-1504 at 2.

additions associated with certain repairs.²²³ Ultimately, the Parties agreed to an average unamortized state ITC balance of \$12,451,000 for the 2012 Test Year.²²⁴

Upon review, the commission finds reasonable the Parties' estimate of unamortized state ITC of \$12,451,000 for the 2012 Test Year.

15.

Working Cash

Working cash (or working cash capital) represents the capital over and above investments in plant and other rate base items to cover the cost of providing service to MECO's customers.²²⁵ In other words, working cash is:

. . . commonly defined as the amount of cash needed by a utility to pay its day-to-day expenses incurred in providing service in relation to the timing of the collection of revenues for those services. In applying this definition, if the timing of a company's cash expenditures, in the aggregate, precedes the cash recovery of those expenses, investors must provide cash working capital. On the other hand, ratepayers are considered the providers of cash working capital in instances where their remittances, on average, precede the company's

²²³See MECO RT-15 at 14-16. See also Settlement Agreement, Exhibit 1 at 100.

²²⁴See Settlement Agreement, Exhibit 1 at 100. See also Stipulated Supplement, Exhibit 1 at 3.

²²⁵See MECO T-17 at 22.

cash disbursements for expenses. Whether "positive" or "negative" in amount, cash working capital is typically included in utility rate base to recognize the timing of cash flows through the utility.

CA-T-1 at 93 (footnote omitted).

MECO's calculation for working cash is discussed in MECO T-17 and detailed in MECO-1707, the Consumer Advocate's review of MECO's working cash calculation is set forth in CA-T-1 pages 92-100, and MECO's revisions to its calculations are discussed in MECO RT-17 pages 7-9 and detailed in MECO-R-1707. Ultimately, the Parties reached agreement on all items related to working cash including: (1) inadvertent errors in their respective calculations; (2) exclusion of "non-cash" expenses (e.g., pension & OPEB regulatory assets, system development costs, and allowance for uncollectable accounts) from the calculation; and (3) the Consumer Advocate's recommendation that MECO's next update to its lead lag study include a work element to ensure that the sample selected for the study is representative of the population from which it is taken.²²⁶ As a result, the Parties initially stipulated to a working cash balance at present rates of \$10,859,000 for the 2012 Test Year, and a change in rate base - working cash of \$202,000, with

²²⁶See Settlement Agreement, Exhibit 1 at 102-104.

target heat rates set at 2012 Test Year levels.²²⁷ Later, the Parties revised their working cash balances to reflect the incorporation of actual regulatory commission expenses and the removal of the allocated expenses for HEI non-incentive compensation and related expenses as set forth in their Stipulated Supplement.²²⁸ Incorporating these changes, the Parties eventually stipulated to a working cash balance at present rates of \$10,852,000 for the 2012 Test Year and a change in rate base - working cash balance of \$200,000.²²⁹

Upon review, the commission finds the Parties' methodology for calculating working cash to be reasonable. However, due to the commission's adjustments to various O&M expenses, as discussed above, the commission approves a 2012 Test Year average consolidated working cash balance of \$10,672,000 at present rates, and change in working cash of \$82,000, for the 2012 Test Year.

²²⁷See Revised Settlement Agreement, Exhibit 1A at 18.

²²⁸See Stipulated Supplement at 1.

²²⁹See id., Exhibit 1 at 3.

' 16.

Average Rate Base

In sum, the commission finds the agreements reached by the Parties with respect to each rate base component for the 2012 Test Year set forth in their Settlement Agreement, as revised and later supplemented, which are discussed above, to be reasonable. However, due to certain commission adjustments, which are discussed in the appropriate sections above, the commission approves as reasonable estimated average rate base balances of \$393,483,000 at present rates, and \$393,401,000 at approved rates for the 2012 Test Year.

17.

Other Rate Base Issues

a.

FASB Interpretation No. 48

FASB Interpretation No. 48 ("FIN 48"), accounting uncertainty in income taxes, as codified in ASC 740-10, provides specific guidance on how to evaluate and quantify income tax uncertainty.²³⁰ MECO states that FIN 48 adjustments represent management's estimate of the difference between the recognized

²³⁰See MECO T-15 at 30.

income tax benefits for book purposes and the benefits claimed on the Company's tax returns.²³¹

For the 2012 Test Year, MECO proposed the following:

Consistent with the treatment agreed to in the settlement agreement in . . . Docket No. 2010-0080 [the HECO 2011 Rate Case], MECO's ADIT is adjusted to include the FIN 48 liability related to UTPs [uncertain tax positions] in the amounts of \$1,166,000 for federal and \$352,000 for state, shown in MECO-WP-1505, pages 6 and 12 (Activities 28418 and 28468, respectively). This is accomplished by an "adjustment" made to ADIT (although categorized as an "exclusion"), reinstating the ADIT associated with the FIN 48 liability or effectively including the FIN 48 liability in rate base. This has the effect of increasing ADIT and decreasing rate base.

MECO T-15 at 31-32. MECO outlines the specific methodology agreed to by the parties in the HECO 2011 Rate Case in its direct testimony (pages 32-34 of MECO T-15), which MECO proposes to implement for ratemaking purposes in this proceeding to account for FIN 48 liabilities.²³² For settlement purposes, the Parties agreed to recommend that the commission approve the same terms for MECO's FIN 48 uncertain tax positions as was agreed upon in the HECO 2011 Rate Case.²³³

²³¹See id. at 31.

²³²See id. at 34.

²³³See Settlement Agreement, Exhibit 1 at 102.

Given the above, the commission finds reasonable the Parties' agreements regarding the methodology and other issues related to the treatment of MECO's FIN 48 uncertain tax positions for the 2012 Test Year.

b.

CIS Project Costs

As agreed to by the Parties in their Audit Stipulation, and approved by the commission in Order No. 31126 in the HECO 2009 Rate Case, \$5.5 million in CIS project costs assigned to MECO will be written-off, and the remainder of the net recoverable costs (not already included in rates), will be included in rate base as of December 31, 2012, in MECO's 2013 RAM revenue adjustment.²³⁴ Given the above, the rate base impact of the CIS project for the 2012 Test Year is no longer an issue.

E.

Rate of Return

As established in previous rate cases,²³⁵ the commission adheres to the guidelines set forth in Bluefield

²³⁴See Supra, Section I.D.

²³⁵See e.g., In re Hawaiian Electric Co., Inc., Docket No. 7766, Decision and Order No. 14412, filed on December 11, 1995, at 47; In re Hawaiian Electric Co., Inc., Docket No. 7700, Decision and Order No. 13704, filed on December 28, 1994,

Waterworks and Improvement Co. v. Pub. Serv. Comm'n, 262 U.S. 679 (1923), and Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591 (1944) in its determination of a fair rate of return. These guidelines prescribe that a fair return must:

- (1) Be commensurate with returns on investments in other enterprises having corresponding risks and uncertainties;
- (2) Provide a return sufficient to cover the capital costs of the business, including service on the debt and dividends on the stock; and
- (3) Provide a return sufficient to assure confidence in the financial integrity of the enterprise to maintain its credit and capital-attracting ability.

Further, the Hawaii Supreme Court in In re Hawaii Electric Light Co., Inc., 60 Haw. 625, 594 P.2d 612 (1979) ("In re HELCO"), articulated the following:

A fair return is the percentage rate of earnings on the rate base allowed a utility after making provision for operating expenses, depreciation, taxes and other direct operating costs. Out of such allowance the utility must pay interest and other fixed dividends on preferred and common stock. In determining a rate of return, the Commission must protect the interests of a utility's investors so as to induce them to provide the funds needed to purchase plant and equipment, and protect the interests of the

at 60-61; In re Hawaiian Electric, Co., Inc., Docket No. 6998, Decision and Order No. 11699, filed on June 30, 1992, at 139-140; In re Hawaii Electric Light Co., Inc., Docket No. 94-0140, Decision and Order No. 15480, filed on April 2, 1997, at 31; and Hawaii Electric Light Company, Inc., Docket No. 05-0315, Decision and Order issued on October 28, 2010, at 88-89.

utility's consumers so that they pay no more than is reasonable.

To calculate the rate of return, the costs of each component of capital - debt, preferred equity and common equity - are weighted according to the ratio each bears to the total capital structure of the company and the resultant figures are added together to yield a sum which is the rate of return.

The proper return to be accorded common equity is the most difficult and least exact calculation in the whole rate of return procedure since there is no contractual cost as in the case of debt or preferred stock[:]

Equity capital does not always pay dividends; all profits after fixed charges accrue to it and it must withstand all losses. The cost of such capital cannot be read or computed directly from the company's books. Its determination involves a judgment of what return on equity is necessary to enable the utility to attract enough equity capital to satisfy its service obligations.

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Questions concerning a fair rate of return are particularly vexing as the reasonableness of rates is not determined by a fixed formula but is a fact question requiring the exercise of sound discretion by the Commission. It is often recognized that the ratemaking function involves the making of "pragmatic" adjustments and there is no single correct rate of return but that there is a "zone of reasonableness" within which the commission may exercise its judgment.

In re HELCO, 60 Haw. at 632-33 and 636, 594 P.2d at 618-20

(citations omitted; emphasis added).

Originally, MECO proposed a capital structure and rates resulting in an overall rate of return of 8.72% for the 2012 Test Year,²³⁶ while the Consumer Advocate recommended a capital structure and rates resulting in an overall rate of return of 7.58%.²³⁷ The sole difference between the Parties' calculations arises from the rate attributed to the common equity component of MECO's capital structure. With respect to this component, MECO contends that a return on common equity ("ROE") of 11.00% is just and reasonable for MECO's 2012 Test Year,²³⁸ while the Consumer Advocate argues that the current cost of equity capital of similar-risk electric utility companies with MECO fall within a range of 9.00% to 9.75%.²³⁹ The Consumer Advocate's witness asserts that "[w]ithin that range, due to the Company's relatively low financial risk and the decoupling to be implemented, I estimate the equity cost of the Company's utility operations to be at the low end of a reasonable range of equity costs for otherwise similar-risk electric utilities - 9.00%."²⁴⁰ Later, in its rebuttal testimony, MECO revised its proposed

²³⁶See MECO-2201 at 2.

²³⁷See CA-T-4 at 4. See also CA-417.

²³⁸See MECO T-19 at 4.

²³⁹See CA-T-4 at 4.

²⁴⁰Id.

ROE 50 basis point downward to 10.50% based on its witness' recommendation to account for changes in capital market conditions, resulting in an overall rate of return of 8.44%.²⁴¹

During negotiations, MECO proposed and the Consumer Advocate agreed that MECO should reflect the benefits of its recent financing efforts (approved by the commission)²⁴² in this proceeding, which were memorialized in letters filed on March 14, 2012, by the HECO Companies in Docket Nos. 2011-0068 and 2011-0127. As a result, the Parties agreed to capitalization and rates for MECO's short-term debt, long-term debt, hybrid securities, and preferred stock as follows:

	<u>Amounts</u>	<u>Weights</u>	<u>Cost Rate</u>	<u>Weighted ER</u> ²⁴³
Short-term Debt	\$ 5,003	1.23%	1.25%	0.02%
Long-term Debt	\$156,370	38.44%	5.06%	1.94%
Hybrid Securities	\$ 9,373	2.30%	7.32%	0.17%
Preferred Stock	\$ 4,744	1.17%	8.25%	0.10%

Settlement Agreement, Exhibit 1 at 105-106; and Settlement Agreement MECO T-20, Attachment 1, Final Settlement at 1. In addition, for the purpose of reaching a global settlement of all

²⁴¹See MECO RT-20 at 1-2; MECO RT-19 at 58.

²⁴²See In re Hawaiian Electric Company, Inc., Hawaiian Electric Light Company, Inc., and Maui Electric Company, Limited, Docket NO. 2011-0068, Decision and Order No. 30268, filed on March 19, 2012; and In re Hawaiian Electric Company, Inc., Hawaiian Electric Light Company, Inc., and Maui Electric Company, Limited, Docket No. 2011-0127, Decision and Order No. 30269, filed on March 19, 2012.

²⁴³Here, "ER" refers to Earnings Requirements.

the issues of this proceeding, the Parties agreed that the interim and final rate increases for MECO's 2012 Test Year should be calculated using a 10.00% ROE, resulting in an rate of return on rate base of 7.91%.²⁴⁴ In support of their negotiated position, the Parties contend that a 10.00% ROE for MECO's 2012 Test Year is consistent with the commission's prior decisions for the HECO Companies' 2009 and 2010 test year rate cases wherein an ROE of 10.00% was approved.²⁴⁵

At the outset, for this proceeding, the commission accepts the Parties' agreements regarding capitalization and cost rates for MECO's short-term debt, long-term debt, hybrid securities, and preferred stock, as set forth in their stipulations, and discussed above. Among other things, the commission approved the HECO Companies' recent refinancing efforts in Docket Nos. 2011-0068 and 2011-0127 during the 2012 Test Year and, thus, the change in MECO's capitalization structure to reflect these efforts is appropriate and reasonable. However, the commission finds the Parties' arguments in support of their stipulated 10.00% ROE for MECO's 2012 Test Year, as described above and set forth in their Settlement Agreement, as revised and later supplemented, to be

²⁴⁴See Settlement Agreement, Exhibit 1 at 107. See also Settlement Agreement, MECO T-22, Attachment 1 at 2; and Stipulated Supplement, Exhibit 1 at 2.

²⁴⁵See Settlement Agreement, Exhibit 1 at 107.

unpersuasive and unreasonable. Instead, the commission finds a 2012 Test Year ROE of 9.00% to be fair and reasonable for MECO. These determinations are based on the following findings and conclusions.

1. While a 10.00% ROE for MECO's 2012 Test Year would be consistent with the ROEs approved by the commission in the HECO 2009 Rate Case, MECO 2010 Rate Case, and HELCO's 2010 test year rate case ("HELCO 2010 Rate Case"), as asserted by the Parties, the commission is not bound by the decisions made in those proceedings, due, among other things, to the differences in the test years. In short, while certain other matters factor into the analysis, the ROE analysis for this proceeding is based on the economic conditions for MECO for the 2012 Test Year, while the ROE analyses for prior rate proceedings were based on the economic conditions for those test years and for those companies.

2. In contrast to the 10.00% ROE stipulated to in the HECO Companies' 2010 test year rate cases, the Parties' ROE stipulation of 10.00% for this proceeding lies outside of range recommend by the Consumer Advocate for MECO's 2012 Test Year (i.e., 9.00% to 9.75%). For instance, in the MECO 2010 Rate Case, MECO proposed an ROE of 10.75%,²⁴⁶ the Consumer Advocate

²⁴⁶See MECO 2010 Final at 85.

recommended a ROE range of 9.50% to 10.50%,²⁴⁷ and the parties ultimately stipulated to an ROE of 10.00%.²⁴⁸ In the HELCO 2010 Rate Case, HELCO proposed an ROE of 10.75% with decoupling and other recovery mechanisms (11.00% without the mechanisms),²⁴⁹ the Consumer Advocate recommended a ROE range of 9.50% to 10.50%,²⁵⁰ and the parties eventually agreed to an ROE of 10.00%.²⁵¹ Similarly, the stipulated 10.00% ROE for the HECO 2011 Rate Case was also within the range recommended by Consumer Advocate in that proceeding.²⁵² Thus, the Parties' stipulated ROE for this proceeding appears to be less defensible and not as substantiated and, thus, less persuasive.

3. The Parties' compromise position on ROE does not adequately appear to reflect the economic and financial market conditions of the 2012 Test Year. Within the 2012 Test Year, the commission requested that the Parties update their ROE

²⁴⁷See id. at 86.

²⁴⁸See id.

²⁴⁹See In re Hawaii Electric Light Company, Inc., Docket No. 2009-0164, Decision and Order No. 30168, filed on February 8, 2012 ("HELCO 2010 Final") at 82.

²⁵⁰See id.

²⁵¹See id. at 84-85.

²⁵²See In re Hawaiian Electric Company, Inc., Docket No. 2010-0080, Decision and Order No. 30505, filed on June 29, 2012 ("HECO 2011 Final") at 125-127.

analyses to reflect current financial market conditions.²⁵³ In response, MECO stated that its position remained unchanged,²⁵⁴ while the Consumer Advocate stated that "current data would support a finding of a lower cost of capital at this time[.]"²⁵⁵ While recognizing that interest rates have fallen since MECO's witness prepared his initial and rebuttal testimonies based on March 2011 and February 2012 data, respectively,²⁵⁶ MECO argues that "interest rate forecasts and the current shape of the yield curve indicate an expected surge in interest rates."²⁵⁷ MECO further contends that reduced interest rates on safe investments do not necessarily mean that the equity market risks have decreased or that investors have materially reduced their return requirements.²⁵⁸ By contrast, based on updated analysis conducted by its witness, the Consumer Advocate states that the "overall average difference in interest rates between 2012 and

²⁵³See PUC-IR-13 issued to MECO via commission letter dated November 14, 2012; and PUC-IR-1 issued to the Consumer Advocate via commission letter dated November 14, 2012.

²⁵⁴See MECO's response to PUC-IR-13 at 1.

²⁵⁵See Consumer Advocate's response to PUC-CA-IR-1 at 6.

²⁵⁶See MECO's response to PUC-IR-13 at 2.

²⁵⁷Id. at 6.

²⁵⁸See id.

2011 is approximately 50 basis points [lower]."²⁵⁹ This conclusion is based on the Consumer Advocate's witness' review of the following: (1) the most recent six-week average of three-year Treasury Bonds ("T-Bonds"); (2) the current trended or "normative" T-Bond yields; (3) the most recent six-week average of BBB-rated utility yields; and (4) the most recent year-ahead projection of 30-year T-Bond yields.²⁶⁰ In addition, the updated ROE analysis conducted by the Consumer Advocate's witness indicates an ROE range of 8.50% to 9.50% for BBB-rated electric utilities based on November 2012 data, compared to the Consumer Advocate's direct testimony recommendation of 9.00% to 9.75% which was prepared in November 2011.²⁶¹ Thus, the Consumer Advocate surmises that its witness' "equity cost estimate for MECO, if performed today, could be at least 25 basis points lower" than that presented in its direct testimony for this proceeding.²⁶²

²⁵⁹See Consumer Advocate's response to PUC-CA-IR-1 at 2.

²⁶⁰See id. at 2-3.

²⁶¹See id. at 5.

²⁶²See id. at 5-6 (emphasis added).

At this time, while forecasts may indicate an increase in interest rates in the future, as argued by MECO, it is undisputed that the financial market conditions have changed since the Parties first submitted their respective analyses regarding ROE.²⁶³ Given the updated analysis discussed above, the commission finds it reasonable to adjust the Parties' stipulated ROE 50 basis points downward to appropriately reflect updated economic and financial market conditions of the 2012 Test Year. Thus, a 9.50% ROE would have been acceptable but for MECO's inability to address certain apparent system inefficiencies, which are discussed in the section below. The commission notes that this level of return reflects MECO's low proportion of purchase power agreement fixed obligations as compared to the other HECO Companies, and MECO's almost 57% common equity ratio.²⁶⁴

4. The commission finds it appropriate to adjust the Parties' stipulated ROE another 50 basis points downward in light of apparent system inefficiencies which negatively impact MECO's customers. For example, MECO appears unable to properly address known renewable energy curtailment issues. For the 2012 Test Year, MECO estimates that its curtailment of wind energy

²⁶³See id. at 2-6; and MECO's response to PUC-IR-13.

²⁶⁴See Stipulated Supplement, Exhibit 1 at 2.

from two wind-farms (Kaheawa Wind Power ("KWP I") and Kaheawa Wind Power II ("KWP II")) is 15,625 MWh, 520 MWh from KWP I, and 15,105 MWh from KWP II.²⁶⁵ In its direct testimony, the Consumer Advocate shared its concerns regarding wind energy curtailment and noted that KWP II curtailment of 15,105 MWh represents approximately 1.00% of MECO's system energy requirements.²⁶⁶ The Consumer Advocate expressed its concerns as follows:

KWP II's energy payment terms are established by the purchased power agreement between KWP II and MECO. The payment rate is a fixed contract rate that depends on the amount of energy purchased. The energy rate is divided into three tiers. The payment terms for KWP II are explained in the testimony of CA-T-3A (Shepherd). The energy payment rates decrease for each tier as the Company purchases more energy from KWP II. There is an economic incentive for the Company to accept all available KWP II energy.

. . . If MECO could curtail less than 15,105 MWh from KWP II, this energy would be purchased at the lowest tier rate. The lowest tier rate is less costly than the cost of MECO's generating units. MECO's generating units range in cost from approximately \$180/MWh to \$300/MWh. In other words, if the KWP II curtailed energy could be accepted, the cost for that energy would be less than if MECO generated the energy from its own generating units. Further, accepting, rather than curtailing, this energy would facilitate MECO's, and through consolidation of the HECO Companies' renewable portfolio results, and the HECO Companies' compliance with the state's renewable portfolio standards requirements.

CA-T-3 at 48-49 (emphasis added).

²⁶⁵See MECO-505 at 19.

²⁶⁶See CA-T-3 at 48.

With a third wind-farm (i.e., Auwahi), which is expected to be operational shortly after the 2012 Test Year, MECO expects to curtail (or dump) 54,429 MWh of wind generated energy annually, 43,686 MWh of that energy from KWP II.²⁶⁷ MECO states that its current "generation system is not equipped to integrate [wind energy] efficiently."²⁶⁸ It further contends that "[w]ithout significant operational upgrades, curtailment of as available generation will increase and regulating reserve requirements will continue to hurt the efficiency of the Maui Electric generation fleet."²⁶⁹ Although, a number of studies were completed several years ago regarding MECO's system proposing specific operational changes and options,²⁷⁰ MECO appears to have failed to adequately and sufficiently plan for and implement the necessary modifications to its existing operations to accept a more appropriate level of the wind energy generation made available to MECO, negatively impacting

²⁶⁷See MECO's response to PUC-IR-16 at 1-2.

²⁶⁸MECO T-7 at 16.

²⁶⁹Id.

²⁷⁰For example, various remedial strategies were discussed and recommended in: (1) KWP II Wind Integration Study conducted by General Electric International in 2010; (2) the Maui Resource Planning Study conducted by PA Consulting Group in 2011; (3) the Operational Flexibility Study for the Integration of Renewable Energy conducted by Stanley Consultants in 2011; and (4) Maui Energy Storage Study conducted by Sandia National Laboratories in 2012. See MECO's response to PUC-IR-15 at 6-11.

ratepayers through higher electricity rates. Additionally, among other matters, MECO appears unable to control operational costs such as pension costs which are discussed above.²⁷¹

5. The commission finds that the authorized ROE of 9.00% would not negatively impact MECO's financial integrity. This decision is supported by the testimony of the Consumer Advocate's cost of capital expert who recommended an ROE of 9.00%.²⁷² In making this recommendation, the Consumer Advocate's witness stated the following:

An equity return of 9.00%, operating through the ratemaking capital structure . . . and the Company's requested embedded capital cost rates produces an overall return of 7.58% for MECO. A 7.58% overall cost of capital affords the Company an opportunity to achieve a pre-tax interest coverage level of 4.61 times. That level of pre-tax interest coverage is well above the pre-tax interest coverage actually realized by MECO over the past five years (2.39x), according to annual and monthly income statements filed with the Hawaii Public Utilities Commission ("Commission" or "PUC") which is shown in the Table II, below.

²⁷¹See Supra, Section II.C.1.a.iii.

²⁷²See CA-4 at 4.

Table II

MECO Interest Coverage Ratios

2007	2.23x
2008	2.82x
2009	2.06x
2010	1.94x
2011 (through June)	2.90x
Five Year Average	2.39x

Therefore, the capital structure and equity return I recommend is sufficient to support the Company's financial position and fulfills the requirement of providing the Company the opportunity to earn a return which is commensurate with the risk of the operation while maintaining the Company's ability to attract capital.

CA-T-4 at 4-5 (table gridlines omitted).

The Consumer Advocate's ROE recommendation presented in its witness' direct testimony reflects its witness' view that MECO has lower financial risk than comparable average companies, due to MECO's higher than average common equity ratio (i.e., MECO has a common equity ratio 56.86%, while the electric industry average is 46.40% and the industry median is 45.80%).²⁷³ In addition, the Consumer Advocate's 9.00% ROE recommendation reflects the lower risk MECO faces as a result of MECO's implementation of the decoupling and other regulatory mechanisms. The commission finds MECO's witness' arguments rebutting the Consumer Advocate's direct testimony ROE

²⁷³See id. at 21-23.

recommendation to be unpersuasive. Further, given the analysis of interest coverage ratios discussed above, an ROE of 9.00% should be sufficient to continue to encourage the appropriate level of investment in MECO and provide assurance to the financial community of MECO's continued financial integrity, while protecting the interest of MECO's customers in paying no more than what is just and reasonable for service. Finally, an ROE of 9.00% (resulting in an overall rate of return 7.34%) is within the range of reasonableness recognized by the Hawaii Supreme Court in In re HELCO.

Based on the foregoing, for the 2012 Test Year, the commission approves as fair and reasonable an ROE for MECO of 9.00%, resulting in an overall rate of return of 7.34%²⁷⁴ as set forth in the capital structure table below.

²⁷⁴The sole difference with respect to this amount and the Consumer Advocate's direct testimony recommended rate of turn of 7.58% is with respect to the Parties' agreement to revise MECO's capital structure to reflect MECO's recent financing efforts.

	(A)	(B)	(C)	(D)
	Amount (000's)	Percentage of Total	Earnings Requirements	Weighted Earnings Requirements (B) x (C)
Short-term Debt	\$ 5,003	1.23%	1.25%	0.015%
Long-term Debt	\$156,370	38.44%	5.06%	1.943%
Hybrid Securities	\$ 9,373	2.30%	7.32%	0.169%
Preferred Stock	\$ 4,744	1.17%	8.25%	0.096%
Common Equity	\$231,310	56.86%	9.00%	5.117%
Total	\$406,894	100%		7.34%

F.

Rate Design

1.

Cost of Service

According to MECO, a cost of service study ("COSS") "is a tool used to determine the cost responsibility of the different rate classes served by MECO for ratemaking purposes."²⁷⁵ For this proceeding, MECO prepared two types of cost studies, one based on embedded or accounting costs and another based on marginal energy costs. With respect to these studies, MECO offers the following:

²⁷⁵MECO T-21 at 5.

An Embedded Cost of service Study, or simply referred to as cost of service study, is a process used to categorize and allocate the total utility costs of providing service (the utility's total revenue requirements) to the various rate classes in order to determine each class's costs responsibility. In contrast, a Marginal Cost Study determines the change in the utility's costs of providing service due to a unit change in kilowatts ("kW"), kilowatthours ("kWh"), or number of customers served by the utility.

MECO T-21 at 5.

MECO summarizes the results of its embedded cost study in its workpapers, MECO-2102 through 2111. The Company's estimated marginal energy cost study for its Maui Division is presented in MECO-2115. According to MECO, marginal energy costs are based on the estimated hourly running costs for 2012, included in its production simulation model.²⁷⁶

The Consumer Advocate contends that the results of the cost studies: (1) are only estimates that are based upon methods and judgments of cost analysts that may vary significantly, and (2) can change significantly from one test period to another, due to shifts in load conditions, varying expense levels, or cost allocation methodology changes.²⁷⁷ Thus, the Consumer Advocate contends that "cost of service results should be used only as a guide in the general direction rate

²⁷⁶See id. at 17.

²⁷⁷See CA-T-2 at 93.

changes should occur, while other factors must also be considered by the Commission."²⁷⁸ The Consumer Advocate elaborates as follows:

Beyond cost of service, other important considerations in the design of rates include:

- Revenue stability and adequacy for the utility - rates should not be abruptly changed, creating a risk that customers may modify their demand levels or migrate between rates, producing unexpected revenue impacts.
- Gradualism in customer impacts - customer acceptance of rate changes is dependent upon avoidance of unexpected monthly bill impacts when usage patterns are unchanged.
- Administrative practicality - rate structures and the relationship between rates must be rational, understandable by customers and simple to apply and understand.
- Public policy priorities such as conservation, economic development or low-income assistance, recognizing that purely cost-based rates may fail to meet other desirable public policy objectives.

CA-T-2 at 93-94.

²⁷⁸Id. (internal quotes omitted).

For the 2012 Test Year, MECO proposes to allocate the revenue increase among the MECO divisions and rate classes as an across-the-board increase to the current effective revenues at each of the MECO divisions, and to the current effective revenues of each of the proposed five rate classes at each of the divisions.²⁷⁹ This allocation, according to MECO is simple, reasonable, and balances the rate and bill impact across all MECO customers. MECO represents that this same proposal was made in the MECO 2007 Rate Case and in the MECO 2010 Rate Case since "an allocation of revenues increase strictly according to cost of service would have resulted in large increases for customers on Lanai and Molokai[.]"²⁸⁰

The Consumer Advocate supports MECO's revenue increase allocation proposal. In so doing, the Consumer Advocate states that MECO's proposal "is reasonable under MECO's circumstances, where cost-based rates are not practical for Lanai and Molokai and where acceptable COSS results are produced on Maui employing such an equal distribution of rate changes."²⁸¹

²⁷⁹MECO T-21 at 8.

²⁸⁰Id.

²⁸¹CA-T-2 at 101.

For settlement purposes, the Parties specifically agreed that MECO's "revenue increase be allocated as proposed in MECO's rebuttal testimony, an equal percentage increase to the three divisions, with an equal percentage increase to each rate class."²⁸²

Based on the forgoing, the commission finds the Parties' agreements regarding the allocation of MECO's revenue increase, as discussed above, to be reasonable for the 2012 Teat Year.

2.

Stipulated Rate Design

"Rate design is the conversion or translation of the Company's proposed revenue requirements for each rate class into pricing structure to collect MECO's required revenues to cover its total costs of providing service."²⁸³ According to MECO, while various factors are considered in the development of proposed rates including, but not limited to, revenue stability, impact on customers, simplicity and ease of understanding, "[i]n general, changes in MECO's rates are aimed at aligning the rate elements closer to the cost components, minimizing intra-class

²⁸²See Settlement Agreement, Exhibit 1 at 109.

²⁸³MECO T-21 at 17.

subsidy, and moving closer to more efficient pricing that provides more accurate price signals."²⁸⁴

With respect to the 2012 Test Year, MECO states that it is proposing the same simplified rate design first proposed in the MECO 2010 Rate Case (i.e., same rate schedules and rate structure, but for Molokai Division's schedule N). Specifically, MECO proposes the following, among other things:

1. Reduce the number of rate schedules by closing Schedules H and U for all three MECO divisions, and Schedule N at Molokai Division.²⁸⁵

2. Simplify pricing on rate schedules by proposing a single demand charge rate for all commercial demand schedules (i.e., Schedules J and P), and proposing a single energy rate for Schedules J, P, and F.²⁸⁶

3. Inclining block tiers are maintained for residential rates at the same kWh levels approved in the MECO 2007 Rate Case.²⁸⁷

4. The optional time-of-use ("TOU") schedules, TOU-R, TOU-G, TOU-J, and TOU-P, for all three divisions, are

²⁸⁴Id. at 18.

²⁸⁵See id.

²⁸⁶See id. at 19.

²⁸⁷See id. at 20.

maintained in their existing form with adjustments to "their prices such that they have the same relationship to the proposed test year 2012 Schedule R, G, J, and P rates as the current Schedules TOU-R, TOU-G, TOU-J, and TOU-P rates have versus the current Schedule R, G, J, and P rates."²⁸⁸

5. A PPAC similar to the one proposed in the MECO 2010 Rate Case is proposed for this proceeding.²⁸⁹ MECO's proposed PPAC is designed to recover reasonably incurred non-energy purchased power contract costs (costs not recovered through the ECAC), including expenses that are currently recovered through the Firm Capacity Surcharge at Maui Division. The PPAC surcharge will be adjusted monthly and reconciled quarterly.²⁹⁰

6. Based on a cost study conducted regarding street lighting fixtures (as agreed to in the MECO 2010 Rate Case), MECO proposes to: (1) increase fixture charges for high pressure sodium fixtures \$2 per month, from \$11 per fixture per month to \$13 per fixture per month; (2) eliminate the fixture charge for 100 watt incandescent fixtures since these are no

²⁸⁸See id.

²⁸⁹MECO's proposed PPAC tariff was approved by the commission in the MECO 2010 Rate Case. See MECO 2010 Final at 104-106.

²⁹⁰See MECO T-21 at 21-24.

longer on the system; and (3) close the fixture charge for 300 watt incandescent fixtures to new customers since it is no longer being supplied as standard equipment.²⁹¹

7. With respect to decoupling, MECO proposes RBA and RAM tariffs consistent with its proposals made in the MECO 2010 Rate Case.²⁹² However, in this proceeding, MECO requests certain modifications to the RBA and RAM tariffs to "reduce regulatory lag" and simplify implementation.²⁹³ The proposed modifications including, among other things, the filing the RBA rate adjustment on December 31 of each year with an effective date of January 1, are set forth and discussed on pages 34-38 of MECO T-21.

The Consumer Advocate states that it supports MECO's efforts for rate simplification first proposed in the MECO 2010 Rate Case and again reflected in MECO's proposed rate design for the 2012 Test Year.²⁹⁴ The Consumer Advocate recommends that MECO's proposed rates in this proceeding should be approved by

²⁹¹See id. at 30.

²⁹²MECO's proposed tariffs to implement the decoupling mechanism approved in Docket No. 2008-0274 for the HECO Companies were approved in the MECO 2010 Rate Case. See MECO 2010 Final at 100-103.

²⁹³See MECO T-21 at 34.

²⁹⁴See CA-T-2 at 102.

the commission, but for certain exceptions.²⁹⁵ With respect to these exceptions, the Consumer Advocate recommends that: (1) the increase in the demand charge for Maui Division's Schedule J not exceed the \$10.00 per kW²⁹⁶; and (2) Maui Division's Schedule P demand charges not be increased beyond \$20.00 per kW, and that Molokai Division's Schedule P demand charge be increased to \$18.00 per kW to effect gradual rationalization of MECO Schedule P pricing across divisions.²⁹⁷ The Consumer Advocate also recommends that the commission reject MECO's proposed changes to the decoupling tariffs since the commission's decoupling docket (i.e., Docket No. 2008-0274) is closed and there is no basis to reopen the proceeding.²⁹⁸ In addition, while in support of MECO's proposed PPAC, the Consumer Advocate recommends that MECO be required to file its PPAC calculations with the commission at least quarterly for review and approval "to ensure that customers are appropriately charge for projected purchase power costs."²⁹⁹

²⁹⁵See id.

²⁹⁶See id. 109.

²⁹⁷See id. at 110.

²⁹⁸See id. at 116.

²⁹⁹See CA-T-3 at 45.

Ultimately, upon negotiations, the Parties stipulate to the following:

1. Adopt the rate design proposed in MECO's rebuttal testimony, which incorporates the Consumer Advocate's recommendations regarding demand charges for Schedules J and P.³⁰⁰

2. MECO's PPAC calculations will be filed with the commission monthly and reconciled quarterly, similar to MECO's ECAC calculations.³⁰¹

3. MECO withdraws its proposed revisions to the effective date for RAM revenue changes.³⁰²

Based on the foregoing, the commission approves as just and reasonable the Parties' agreements regarding rate design, as set forth in their Settlement Agreement, as revised, and discussed above.

³⁰⁰See Settlement Agreement, Exhibit 1 at 110.

³⁰¹See id.

³⁰²See id. MECO, and the other HECO Companies, may propose these revisions in the new commission investigation instituted to reexamine the existing decoupling mechanisms for the HECO Companies which is being commenced concurrently with the issuance of this Decision and Order.

ECAC

ECAC is "an automatic adjustment provision in the utility's rate schedules that allows the utility to automatically increase or decrease charges to reflect the change in the Company's energy costs of fuel and purchased energy above or below the levels included in base charges without a rate proceeding."³⁰³ The purpose of the ECAC, according to MECO, is to address price changes in its cost of fuel and purchased energy, and to accommodate changes in the actual mix of generation, distributed generation ("DG"), and purchased energy resources, without the need for a rate case.³⁰⁴ MECO explains further, as follows:

A rate case proceeding determines the base electricity rates in which there are embedded test year levels of fuel prices, payment rates for purchased energy and a test year resource mix. The ECAC mechanism, expressed in cents per kWh, allows the Company to recover from, or return to, customers costs due to subsequent changes in: (1) fuel and purchased energy costs; (2) the resource mix between utility-owned generation, utility-DG and purchased energy; (3) the resource mix among the utility plants; and (4) the resource mix among purchased energy producers. Prior rate case proceedings established a fixed efficiency factor, or sales heat rate, for the utility central station generation to encourage efficient operation of

³⁰³MECO T-4 at 10.

³⁰⁴See id. at 10-11.

the system units. An ECA factor, which sets the rate adjustment that reflects these changes for the coming month, is filed with the Commission monthly.

MECO T-4 at 11.

Act 162, SLH 2006 ("Act 162"), was codified as HRS § 269-16(g), and took effect on June 2, 2006. This statute requires that any automatic fuel rate adjustment clause that is requested by a public utility in an application filed with the commission be designed to meet certain factors, as determined by the commission's discretion.³⁰⁵

³⁰⁵Specifically, under HRS § 269-16(g), MECO's ECAC must be designed, as determined in the commission's discretion, to:

- (1) Fairly share the risk of fuel cost changes between the public utility and its customers;
- (2) Provide the public utility with sufficient incentive to reasonably manage or lower its fuel costs and encourage greater use of renewable energy;
- (3) Allow the public utility to mitigate the risk of sudden or frequent fuel cost changes that cannot otherwise reasonably be mitigated through other commercially available means, such as through fuel hedging contracts;
- (4) Preserve, to the extent reasonably possible, the public utility's financial integrity; and
- (5) Minimize, to the extent reasonably possible, the public utility's need to apply for frequent applications for general rate increases to account for the changes to its fuel costs.

HRS § 269-16(g).

For this proceeding, MECO mirrors the positions taken by the HECO Companies in their prior rate cases, and states "that the current level of ECAC fuel price risk-sharing is appropriate and that no change is necessary to the current ECAC risk-sharing approach."³⁰⁶ MECO also asserts that its existing ECAC is consistent with Act 162.³⁰⁷ Based on its evaluation of MECO's ECAC under HRS § 269-16(g),³⁰⁸ the Consumer Advocate does not object to the continuation of MECO's ECAC, and contends that MECO's ECAC "provides a fair sharing of the risks of fuel costs changes between the Company and its ratepayers in a manner that preserves the financial integrity of the Company without the need for frequent rate filings."³⁰⁹

Here, based on the record and consistent with the commission's determinations in prior rate cases involving the HECO Companies,³¹⁰ the commission will allow MECO's existing ECAC

³⁰⁶MECO T-21 at 27-28.

³⁰⁷Support for MECO's position regarding compliance with Act 162 is set forth in T-21 at pages 25-30.

³⁰⁸See CA-T-3 at 35-42.

³⁰⁹Id. at 42.

³¹⁰The commission applied the requirements of HRS § 269-16(g) in the HECO Companies' last four rate case proceedings (i.e., HECO 2009 Rate Case, HELCO 2010 Rate Case, MECO 2010 Rate Case and HECO 2011 Rate Case). In the HECO 2009 Rate Case proceed (i.e., Docket No. 2008-0083), the commission discussed in detail the findings in support of continue HECO's ECAC and concluded that HECO's ECAC complies with the

design to continue at this time.³¹¹ Nonetheless, the commission reminds MECO that the interest of customers must be protected in order for shareholders' interests to continue to be protected under MECO's current ECAC design. In a recent proceeding involving HECO's fuel oil contracts, the commission articulated the following:

[T]he commission notes that it expects HECO to engage in fuel procurement with its fullest attention in order to provide maximum value to customers. As the Parties are well aware, fuel costs, which are subject to high volatility, are essentially passed through to ratepayers via the ECAC. Under its present design, it appears that the ECAC achieves the design criteria set forth in HRS § 269-16(g)(3) - (5), quoted above (i.e., allows HECO to mitigate the risk of sudden or frequent fuel cost changes, preserves its financial integrity, and minimizes the need to apply for frequent rate cases). However, it bears restating that the ECAC must also be

requirements of HRS § 269-16(g). See In re Hawaiian Electric Company, Inc., Final Decision and Order, filed on December 29, 2010, in Docket No. 2008-0038, at 64-72. Similarly, the commission concluded that the ECAC provisions of the HECO Companies in their 2010 and 2011 rate cases also complied with the requirements of HRS § 269-16(g) and, thus, should be allowed to continue. See HELCO 2010 Final at 96; MECO 2010 Final at 99-100; and HECO 2011 Final at 136.

³¹¹Similar to the PPAC and decoupling, the commission approved and adopted for implementation MECO's proposals regarding target heat rates, deadbands, and provisions to change target heat rates in the MECO 2010 Rate Case. See MECO 2010 Final at 100-103. Additionally, in the Interim Decision and Order, as agreed to by the Parties, the commission authorized MECO to reset its target heat rates by fuel type to 2012 Test Year levels for the purpose of calculating ECAC when interim rates were approved. See Interim Decision and Order at 13-16, and 35-36.

designed to "[f]airly share the risk of fuel cost changes between the public utility and its customers" and "[p]rovide the public utility with sufficient incentive to reasonably manage or lower its fuel costs and encourage greater use of renewable energy[.]" To this end, the commission believes that HECO has a public interest duty and responsibility to its customers to adopt and implement best-in-class fuel procurement strategies and practices. While HECO is exploring changes to its fuel supply portfolio in the near future for environmental compliance and other reasons, the time is particularly ripe to consider enhancing existing fuel procurement practices to be more commercially oriented and customer focused. In sum, customer interests must be paramount and adequately protected in order for shareholders' interests to continue to be protected under HECO's existing fuel procurement strategies and ECAC design.

In re Hawaiian Electric Company, Inc., Docket No. 2012-0217, Decision and Order No. 31213, filed on April 30, 2013, at 21-22 (footnote omitted). The commission's concerns regarding fuel procurement practices set forth in Decision and Order No. 31213 are also applicable to MECO. The extent to which the HECO Companies actively pursue implementation of new and innovative operating practices to reduce fuel costs and minimize curtailment of renewable energy would inform the commission's perspective and future actions on these matters.

G.

Curtailment of Renewable Energy

For the 2012 Test Year, MECO estimates its curtailment (or dumping) of wind energy to be 15,625 MWh³¹² and, in the near future, MECO expects curtailment of wind generated energy to increase to 54,429 MWh annually.³¹³ As discussed previously in this Decision and Order, curtailment of renewable energy generation imposes a significant cost on MECO ratepayers.

For example, MECO estimates the average energy cost of the total curtailed wind energy for the Maui Division is 11.953 cents per KWh.³¹⁴ By refusing to take this low cost, curtailed wind energy regardless of the reason(s), MECO has to utilize additional utility fossil fuel generation. The average energy cost for MECO's fossil fuel generation for the Maui Division for the 2012 Test Year is 20.843 cents per KWh.³¹⁵

³¹²See MECO-505 at 19.

³¹³See MECO's response to PUC-IR-16 at 1-2. Actual wind curtailment could be even higher since by MECO's own admission, these estimates exclude an unknown amount of embedded curtailed wind energy for KWP1 and KWP2.

³¹⁴Id. at 2-3.

³¹⁵Average energy costs for MECO fossil generation is the result of dividing annual fuel expense of \$198,123,000 by the test year fossil generation of 950,533 MWhs. See MECO-501 and MECO-502, respectively.

According to the Maui Energy Storage Study ("MESS") prepared by Sandia National Laboratories, and submitted by MECO in its response to PUC-IR-15, the "must run" designation of certain units at KPP contributes to curtailment of renewable energy,³¹⁶ which negatively impacts MECO's customers through higher electricity rates. While MECO's use of its units in KPP have been examined in various studies, MECO appears to be reluctant to fully commit to the retirement, reduction in use, or re-designation of its KPP units, even in light of abundant available wind energy on Maui.

MECO's four steam units at KPP, known as Kahului 1-4 ("K1, K2, K3, and K4", as applicable), which combined can provide MECO's system with approximately 34 MW of capacity, were first placed into operation in 1948, 1949, 1954 and 1966, respectfully.³¹⁷ K1 and K2 were initially scheduled for retirement in 1998 and 1999, respectfully, and then deferred to 2005 and 2006, based on a remaining useful life ("RUL") study conducted by MECO in 1995.³¹⁸ Later, based on an RUL study conducted in 1999, MECO further delayed the scheduled retirement

³¹⁶See MECO's response to PUC-IR-15, Attachment D4 at 34 (Revised 3/11/13).

³¹⁷See MECO-701 at 1.

³¹⁸See Maui Electric Company Limited IRP Plan 2000-2020, filed on May 31, 2000, in Docket No. 99-0004 ("MECO's 2000 IRP"), at 5-20 - 5-21.

of its KPP units to 2025, as set forth in MECO's 2000 IRP.³¹⁹ This decision was based on a determination that it was cost-effective to continue to use the existing units since, among other things, the continued operation of the existing units deferred the need to install new generation and allowed for newer technologies, including renewable energy, to develop and mature.³²⁰ MECO in its 2007 IRP, assumed the same 2025 retirement schedules for the KPP units.³²¹ During MECO's 2007 IRP, MECO discussed a "hypothetical" retirement of its KPP generating units in 2015 (at the earliest) based on the installation of replacement generating capacity at a new plant.³²²

The commission notes that the total 2012 Test Year revenue requirements associated with KPP is estimated by MECO to be \$51,819,400 annually.³²³ This translates into a busbar cost of energy of 30.062 cents per KWh which is more than 2.5 times

³¹⁹See id. at 5-21 - 5-23.

³²⁰See id. at 5-22.

³²¹See Maui Electric Company, Ltd. Integrated Resource Plan 2007-2026, filed on April 30, 2007 in Docket No. 04-0077 ("MECO's 2007 IRP") at 5-19 - 5-21.

³²²See id. at 8-24 - 8-25.

³²³See MECO's response to PUC-IR-15, Attachment B at 1. As noted by MECO, this estimate does not include any employee benefits and payroll taxes for plant employees or any corporate administrative costs such as property insurance.

higher than the average cost of curtailed wind.³²⁴ Further, KPP has average fuel conversion efficiency (heat rate) of 14,228 BTUs/KWh and therefore is substantially less fuel efficient than MECO's diesel-fired generators on Maui which have an average heat rate of 9,432 BTUs/KWh.³²⁵ Based upon the foregoing, MECO should be aggressively pursuing more cost effective alternatives.

Since filing its IRPs in 2000 and 2007, MECO's system has undergone various changes including integration of energy purchased from renewable energy generators. For instance, by 2013, three wind-farms (i.e., KWP I, Auwahi, and KWP II) with the combined capacity of 72 MW of electricity will be providing power on MECO's system.³²⁶ Appropriate integration of wind generation has been a challenge for MECO's system, requiring modifications and operational changes to the running of MECO's units, including those at KPP.³²⁷ With three wind-farms operational, MECO expects to curtail (or dump) 54,429 MWh of wind generated energy annually, 43,686 MWh of that energy

³²⁴The busbar cost is the result of dividing annual revenue requirements of \$51,819,400 by test year KPP generation of 172,376 MWh. See MECO-WP-503 at 112.

³²⁵See MECO-504 at 1.

³²⁶See MECO T-7 at 16.

³²⁷See id. at 19-21.

from KWP II.³²⁸ This amount of wind curtailment represents almost 6.00% of the 2012 Test Year annual fossil generation for the Maui Division and an indication of the volume of fossil fuel transshipped and imported into Maui that could be avoided.³²⁹ According to MECO, its current system cannot integrate wind energy efficiently and that "[w]ithout significant operational upgrades, curtailment of as available generation will increase and regulating reserve requirements will continue to hurt the efficiency of the Maui Electric generation fleet."³³⁰

There are a number of completed studies that recommend specific remedial strategies and scenarios to reduce the level of wind energy curtailment, including:

- KWP II Wind Integration Study conducted by General Electric International in 2010;
- Maui Resource Planning Study conducted by PA Consulting Group in 2011;
- Operational Flexibility Study for the Integration of Renewable Energy conducted by Stanley Consultants in 2011; and
- MESS conducted by Sandia National Laboratories in 2012.

³²⁸See MECO's response to PUC-IR-16 at 1-2.

³²⁹This percentage is the result of 54,429 MWh of wind curtailment divided by 950,533 MWh of Maui Division net fossil generation. See MECO-502 at 1.

³³⁰MECO T-7 at 16.

See MECO Response to PUC-IR-15 at 6-8. In addition, MECO identifies other studies in progress that assess MECO's current system, promote system efficiencies, and increase integration of wind energy on Maui. Specifically, as identified on pages 8 through 11 of MECO's response to PUC-IR-15, MECO notes that final versions of the following studies will be completed in 2013: the Generation Performance and Reserve Study/Analysis of Cycling Costs & Countermeasure Recommendations ("Generation Performance & Reserve Study") by Electric Power Systems/Intertek Aptec; and the Hawaii Solar Integration Study ("HSIS") by GE Energy Consulting.

The commission notes that some of these studies recommend options and scenarios to increase integration of renewable energy that involve portions and/or all of MECO's KPP generating units being retired and/or "mothballed" prior to 2025,³³¹ MECO's purported retirement schedule for its KPP units.³³² In particular, the MESS found that MECO could reduce or eliminate the operation of KPP units by installing a battery

³³¹See MECO-702 at 1-36 (Maui Resources Planning Study, Interim Report); and MECO's Response to PUC-IR-15, Attachment D4, Revised March 11, 2013 (i.e., the MESS).

³³²Despite numerous studies, the fact that MECO continues to operate an old, inefficient high cost generator begins to call into question whether MECO has sufficient incentive to reasonably manage or lower fuel costs.

energy storage system and appears to indicate that there are significant potential benefits from reducing or eliminating the use of the KPP units.³³³ In its response to PUC-IR-15, MECO informed the commission that accepting more wind energy instead of operating the units at KPP would result in savings of approximately \$6,904,100 annually (which is an estimate of the savings in fuel and purchased power expense, but does not account for any additional costs or savings associated with modifying the "must-run" designation of certain units at KPP).³³⁴ However, due to certain operational constraints and other concerns, MECO states that it plans to continue KPP operations as they presently stand.³³⁵

The commission is not satisfied with MECO's response. MECO has initiated or participated in a number of comprehensive studies over the last three years relating to the operation of its fossil generation fleet and integration of additional renewable energy resources. These studies were conducted by respected National Laboratories or mainland consulting firms and contained specific remedial strategies and options that MECO

³³³See MECO's response to PUC-IR-15, Attachment D4 at 29 (Revised 3/11/13).

³³⁴See MECO's response to PUC-IR-15 at 13. There are no adverse economic consequences for MECO if they withhold cheaper renewable energy from customers, regardless of reason.

³³⁵See id. at 21-22.

could implement to reduce operating costs and amount of curtailed wind energy. While the commission is aware that MECO plans to continue studying integration issues, MECO can and should implement certain corrective operational changes that have already been recommended in various studies to reduce operational costs and achieve further integration of renewable resources on Maui. Accordingly, within 90 days of the date of this Decision and Order, MECO shall provide a detailed strategy and action plan to: (1) improve operational efficiency, and (2) reduce curtailment of renewable energy ("System Improvement and Curtailment Reduction Plan"). Within this plan, the following topics should be addressed, at minimum:

- (1) Plans and progress to date on implementation of recommendations to reduce or eliminate curtailment of renewable energy and lower total system costs, including but not limited to those recommendations and proposed investments evaluated in the MESS, the Generation Performance & Reserve Study, and the HSIS;
- (2) The elimination of must run designation and/or retirement of the units at KPP;
- (3) Other options that MECO may have identified to accept more renewable energy or otherwise lower total system costs, such as, for example, investments at independent power producer facilities to provide increased down reserve and other ancillary services or other strategies to reduce curtailment;

- (4) Other load shifting incentives such as a very low dumped power rate offered to customers to shift customer demand to times when excess renewable energy would otherwise be curtailed;
- (5) Utilization of demand response programs and energy storage technologies to reduce the need for on-line fossil generation to provide operating reserves and other ancillary services; and
- (6) A comprehensive evaluation of all fixed and variable costs, as well as all system benefits (including fuel savings, O&M expense savings, system efficiency savings, etc.) estimated to result from curtailment reduction strategies underway or proposed in the System Improvement and Curtailment Reduction Plan.

Furthermore, within 30 days of the date of this Decision and Order, MECO shall make the following information available to the public on its website beginning with January 2013: (1) the quantity of wind energy accepted per month; (2) the quantity of wind energy curtailed per month; and (3) an estimate of the cost of curtailment to ratepayers. The methodology for estimating the cost of curtailment to ratepayers shall be the difference between the average cost of curtailed wind energy and the average monthly energy cost of MECO's fossil generation. This information should be easily accessible from MECO's homepage and the information should be filed with the commission in this docket on a monthly basis. MECO shall inform each of its customers as to the availability of this information

on its website. MECO is further encouraged to provide additional system operation data on its website, as appropriate, to increase transparency of its system operations and demonstrate reasonableness of its operation.

H.

Refund Required

In the Interim Decision and Order, the commission stated the following:

MECO will be required to refund to its customers any excess collected under this Interim Decision and Order, together with such interest as provided for by HRS § 269-16(d), if the final increase approved by the commission is less than the total interim increase granted by this Interim Decision and Order. This refund requirement is acknowledged by MECO.

Interim Decision and Order at 32 (footnote omitted).

The increase in revenues over present rates approved by the commission in this Decision and Order is less than the increase in revenues over present rates previously approved by the commission in the Interim Decision and Order. Thus, MECO must refund to its ratepayers the amounts it collected in excess of the increase authorized by this Decision and Order, together with interest, pursuant to HRS § 269-16(d).

I.

Commission's Observations and Perspectives

The commission's observations and perspectives are attached as Exhibit C to this Decision and Order.

III.

Summary of Findings and Conclusions

The commission finds and concludes:

1. The revenues, expenses, and average depreciated rate base balance, as set forth in the attached schedules, are reasonable and are approved for MECO's 2012 Test Year.

2. A fair and reasonable ROE for MECO for the 2012 Test Year is 9.00%, as discussed in Section II.E of this Decision and Order, and the resulting composite cost of capital (or overall rate of return) of 7.34% is also fair and reasonable, and approved.

3. On a consolidated operations basis, MECO is entitled to: (a) an increase in revenues of \$5,334,000, or approximately 1.29% over revenues at present rates; and (b) total operating revenues of \$418,901,000.

4. The commission's \$233,936 downward adjustment to MECO's post-CIS project O&M expenses for project stabilization, as discussed in Section II.C.1.a.i of this Decision and Order, is reasonable.

5. The commission's \$1,262,000 net downward adjustment to MECO's A&G O&M expenses, as discussed in Section II.C.1.a.ii of this Decision and Order, is reasonable.

6. The commission's \$980,000 downward adjustment to MECO's O&M expenses for Future Studies, as discussed in Section II.C.1.a.iii of this Decision and Order, is reasonable.

7. The commission's \$806,000 downward adjustment to MECO's O&M expenses associated with IRP labor and a non-labor costs, as discussed in Section II.C.1.a.iv of this Decision and Order, is reasonable.

IV.

Orders

THE COMMISSION ORDERS:

1. The Parties' Settlement Agreement, filed on April 20, 2012, as revised and later supplemented, is approved, with the adjustments made by the commission in this Decision and Order.

2. MECO may increase its rates to produce a total annual revenue increase of \$5,334,000, or approximately 1.29% over revenues at present rates (consolidated operations basis) as shown on the schedules attached to this Decision and Order, representing an increase in MECO's revenue requirements to \$418,901,000 for the 2012 Test Year (consolidated operations basis).

3. The final approved revenue increase of \$5,334,000 approved in this Decision and Order is less than the revenue increase of \$13,089,000 previously approved by the commission on an interim basis. Thus, pursuant to HRS § 269-16(d), MECO must refund its ratepayers the amount it has collected that are in excess of the increase authorized by this Decision and Order, together with interest. MECO shall file its refund plan within 15 days from the date of this Decision and Order.

4. The final increase in rates approved herein shall take effect on June 1, 2013. MECO shall file its revised results of operations, supporting schedules and tariff sheets reflecting the commission's decisions herein as soon as reasonably practicable for the commission's review and approval, and the same shall be served on the Consumer Advocate. The Consumer Advocate may file comments within 14 days of MECO's filing.

5. Within 30 days from the date of this Decision and Order, MECO shall file all appropriate documentation regarding the re-setting of its target heat rate with respect to Auwahi.

6. Within 90 days from the date of this Decision and Order, MECO shall file its System Improvement and Curtailment Reduction Plan, consistent with the requirements discussed in Section II.G of this Decision and Order.

7. Within 30 days of the date of this Decision and Order, MECO shall make its curtailment information, as discussed in Section II.G of this Decision and Order, readily available to the public on its website.

DONE at Honolulu, Hawaii MAY 31 2013.

PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

By *Hermina Morita*
Hermina Morita, Chair

By *Michael E. Champley*
Michael E. Champley, Commissioner

APPROVED AS TO FORM:

By *Lorraine H. Akiba*
Lorraine H. Akiba, Commissioner

Ji Sook Kim
Ji Sook Kim
Commission Counsel
2011-0092.ac

MAUI ELECTRIC COMPANY, LIMITED
MECO CONSOLIDATED
RESULTS OF OPERATION
2012
(\$ IN 000'S)

	<u>PRESENT RATES</u>	<u>ADDITIONAL AMOUNT</u>	<u>APPROVED RATES</u>
Operating Revenues			
Electric Sales	411,657	5,158	416,815
Other	1,910	176	2,086
Total Operating Revenues	<u>413,567</u>	<u>5,334</u>	<u>418,901</u>
Operating Expenses			
Operations and Maintenance			
Fuel	212,580	-	212,580
Purchased Power	44,856	-	44,856
Production	27,818	-	27,818
Transmission	2,963	-	2,963
Distribution	10,151	-	10,151
Customer Accounts	4,683	-	4,683
Allowance for Uncollectibles	301	-	301
Customer Service	1,986	-	1,986
Administrative and General	15,262	-	15,262
IRP Adjustment	(806)	-	(806)
Future Study Costs	(980)	-	(980)
Total Operations and Maintenance	<u>318,814</u>	<u>-</u>	<u>318,814</u>
Depreciation and Amortization	19,687	-	19,687
Amortization of State ITC	(272)	-	(272)
Taxes, Other Than Income Taxes	38,520	470	38,989
Interest on Customer Deposits	280	-	280
Income Taxes	10,629	1,893	12,522
Total Operating Expenses	<u>387,658</u>	<u>2,362</u>	<u>390,020</u>
Net Operating Income	<u>25,909</u>	<u>2,972</u>	<u>28,881</u>
Average Depreciated Rate Base	<u>393,483</u>	<u>(82)</u>	<u>393,401</u>
Rate of Return	<u>6.58%</u>		<u>7.34%</u>

MAUI ELECTRIC COMPANY, LTD.
CONSOLIDATED
ANALYSIS OF RATE INCREASE
(\$ IN 000'S)

	<u>AMOUNT</u>	<u>% INCREASE</u>
RATE INCREASE		
ELECTRIC REVENUES	5,158	1.25%
OTHER REVENUES	<u>176</u>	<u>9.21%</u>
TOTAL INCREASE	5,334	1.29%
Less:		
INTERIM INCREASE	13,089	3.16%
Interim D&O No. 30396, Filed May 21, 2012		
	<u> </u>	
FINAL INCREASE/(DECREASE)	<u><u>(7,755)</u></u>	-1.88%

MAUI ELECTRIC COMPANY, LTD.
CONSOLIDATED
2012 INCOME TAX EXPENSE
(\$ IN 000'S)

	<u>PRESENT RATES</u>	<u>ADDITIONAL AMOUNT</u>	<u>APPROVED RATES</u>
Operating Revenues	<u>413,567</u>	<u>5,334</u>	<u>418,901</u>
Operating Expenses			
Fuel Oil and Purchased Power	257,436	-	257,436
Other Operation and Maintenance Expense	61,378	-	61,378
Depreciation	19,687	-	19,687
Amortization of State ITC	(272)	-	(272)
Taxes Other Than Income Tax	38,520	470	38,989
Interest on Customer Deposits	280		280
Total Operating Expenses	<u>377,029</u>	<u>470</u>	<u>377,498</u>
Operating Income Before Income Taxes	<u>36,538</u>	<u>4,864</u>	<u>41,403</u>
Tax Adjustments			
Interest Expense	(8,369)	-	(8,369)
Meals and Entertainment	19	-	19
Total Tax Adjustments	<u>(8,350)</u>	<u>-</u>	<u>(8,350)</u>
Taxable Income	<u>28,188</u>	<u>4,864</u>	<u>33,053</u>
Income Tax			
Tax Rate 38.9100%	<u>10,968</u>	<u>1,893</u>	<u>12,861</u>
Tax Benefit of domestic Production Activities Deductions	339	-	339
Total Income Tax Expense	<u>10,629</u>	<u>1,893</u>	<u>12,522</u>

MAUI ELECTRIC COMPANY, LIMITED
CONSOLIDATED
TAXES OTHER THAN INCOME TAXES
(\$ IN 000'S)

	<u>%</u>	<u>PRESENT RATES</u>	<u>ADJUSTMENT</u>	<u>APPROVED RATES</u>
Electric Sales Revenue		411,657	5,158	416,815
Other Operating Revenue		1,910	176	2,086
Operating Revenues		<u>413,567</u>	<u>5,334</u>	<u>418,901</u>
Public Service Tax	5.885%	24,321	314	24,635
PUC Fees	0.500%	2,066	27	2,093
Franchise Tax	2.500%	10,284	129	10,413
Payroll Tax		<u>1,849</u>	<u>-</u>	<u>1,849</u>
TOTAL TAXES OTHER THAN INCOME TAX		<u>38,520</u>	<u>470</u>	<u>38,989</u>

**MAUI ELECTRIC COMPANY, LTD.
CONSOLIDATED
2012 AVERAGE RATE BASE
(\$ IN 000'S)**

	Beginning Balance	End of Year Balance	Average Balance
Investments in Assets Serving Customers			
Net Cost of Plant in Service	465,783	493,298	479,541
Property Held for Future Use	1,303	1,303	1,303
Fuel Inventory	18,577	18,577	18,577
Materials and Supplies Inventories	13,387	13,387	13,387
Unamortized Net SFAS 109 Regulatory Asset	8,405	8,642	8,524
Pension Asset	3,453	4,377	3,915
OPEB Regulatory Asset	344	261	303
Unamortized System Development Costs	1,240	1,487	1,364
Contributions in Excess of NPPC Reg. Asset	3,101	8,400	5,751
Total Investments in Assets	515,593	549,732	532,663
Funds from Non-Investors			
Unamortized CIAC	74,766	83,821	79,294
Customer Advances	4,649	4,599	4,624
Customer Deposits	4,346	4,812	4,579
Accumulated Deferred Income Taxes	42,143	55,666	48,905
Unamortized State ITC	12,150	12,752	12,451
Total Deductions	138,054	161,650	149,852
Difference			382,811
Working Cash at Present Rates			10,672
Rate Base at Present Rates			393,483
Change in Rate Base - Working Cash			(82)
Rate Base at Approved Rates			393,401

Commission's Observations and Perspectives

The commission believes it is timely, necessary and essential to outline fundamental, emerging issues pertaining to the operation and regulation of investor-owned electric utilities in Hawaii to set a course that is mutually beneficial to utility shareholders and utility ratepayers.

The commission has observed that electric customers are increasingly frustrated because of high electric rates.¹ These concerns were also expressed by the 2013 Hawaii State Legislature in connection with Senate Bill 120, Session Laws of Hawaii 2013, which authorizes the commission "to establish a policy to implement economic incentives and cost recovery regulatory mechanisms, as necessary and appropriate, to induce and accelerate electric utilities' cost reduction efforts, encourage greater utilization of renewable energy, accelerate the retirement of utility fossil generation, and increase investments to modernize the State's electrical grids."² Therefore, the commission's Decision and Order in the instant docket and the simultaneous filing of the decoupling mechanism

¹See testimony presented at commission held public hearings for HECO Companies' 2010, 2011, and 2012 test year rate cases as well as the written public testimony submitted in these dockets.

²See Senate Bill No. 120, Senate Draft 1 at 3. Senate Bill No. 120, Senate Draft 1 was signed into law on April 22, 2013 as Act 37, Session Laws of Hawaii 2013.

investigation is intended to serve notice to Maui Electric Company, Limited ("MECO"), as well as the other HECO Companies.³

The commission understands the importance of and supports the concept of delinking electricity sales from revenue. However, existing automatic adjustment mechanisms appear to unduly insulate the HECO Companies from the need or urgency to make major adjustments to current utility management and operational practices, thus offering no motivation to implement strategies and action plans that may be more conducive to serving the public interest.

The commission is concerned that the 2008 "Energy Agreement"⁴ may be the principal foundation for HECO Companies' overall business strategy.⁵ The HECO Companies' over-reliance upon a link between the Agreement and utility financial health

³"HECO Companies" refers to MECO, and its affiliate entities, Hawaiian Electric Company, Inc. ("HECO"), and Hawaii Electric Light Company, Inc. ("HELCO"). Structurally, MECO and HELCO are subsidiaries of HECO, while HECO is a subsidiary of Hawaiian Electric Industries, Inc. ("HEI").

⁴"Energy Agreement" (or the "Agreement") refers to the "Energy Agreement Among the State of Hawaii, Division of Consumer Advocacy of the Department of Commerce and Consumer Affairs, and the Hawaiian Electric Companies," executed on October 20, 2008, by the former Governor of the State of Hawaii, the Department of Business, Economic Development, and Tourism, the HECO Companies, and the Consumer Advocate.

⁵See HEI Financial Community Meetings presentation, March 4-8, 2013 at 3, 4 and A1, available at <http://phx.corporate-ir.net/phoenix.zhtml?c=101675&p=irolcalendar>.

obfuscates utility performance and ultimately customer service and satisfaction. The commission affirms its commitment and support of Hawaii's clean energy transformation. However, clean energy in and of itself is not the singular goal but rather should be viewed as one strategy to serve the public interest along with sound business practices centered on customer value.⁶

From the commission's perspective, the HECO Companies appear to lack movement to a sustainable business model to address technological advancements and increasing customer expectations. The commission observes that some mainland electric utilities have begun to define, articulate and implement the vision for the "electric utility of the future." Without such a long-term, customer focused business strategy, it is difficult to ascertain whether HECO Companies' increasing capital investments are strategic investments or simply a series of unrelated capital projects that effectively expand utility rate base and increase profits but appearing to provide little or limited long-term customer value. While a public utility is required to have a reasonable opportunity to earn a fair financial return, attractive financial returns are not an entitlement by virtue of being a regulated utility.

⁶Key elements of the Agreement, such as Renewable Portfolio Standards and Energy Efficiency Portfolio Standards, have been codified in legislation. As a result, the HECO Companies are required to comply with these and all other applicable statutes as the normal course of business.

The HECO Companies have characterized various automatic adjustment mechanisms that are used as regulatory cost recovery as an "Improved Regulatory Model"⁷ for security analysts in lieu of traditional general rate cases. Unfortunately, these automatic adjustment clauses are not linked to key performance measures such as rate affordability and customer satisfaction.

The commission believes that a well-managed, customer focused electric utility is one that is driven by a management philosophy and corporate culture to provide superior customer value through affordable electric rates and outstanding customer service, as defined by its customers. Top performing utilities embrace a well-researched phenomenon known as the virtuous cycle or virtuous circle where positive performance drives positive regulatory outcomes, which drive positive financials, which can then be reinvested in the utility to keep that cycle going.⁸

Conversely, the opposite phenomenon, a "vicious cycle" also can happen. Poor performance drives poor regulatory

⁷See HEI First Quarter 2013 Financial Results and Outlook, May 8, 2013, at 22, available at <http://phx.corporate-ir.net/phoenix.zhtml?c=101675&p=irol-calendar>.

⁸See Florida Power & Light's Virtuous Circle management philosophy in NextEra Energy Investor Conference 2013 presentation, March 12, 2013, at 23, available at <http://www.investor.nexteraenergy.com/phoenix.zhtml?c=88486&p=irol-presentations>. See Andrew Heath, A Virtuous Cycle, October 2012, Public Utilities Fortnightly.

outcomes and financial penalties starting a downward cycle in the opposite direction.

The virtuous cycle is readily apparent to those who follow and critically analyze electric utility financial performance. As a result, it is common knowledge among these professionals which utilities are top industry performers and whether the HECO Companies are recognized among the industry's elite performers in this regard.

The extent of the HECO Companies' own volition to achieve high performance, provide excellent customer service and affordable rates will determine the appropriate amount of regulatory oversight required. Otherwise, the commission would be forced to employ arduous regulatory scrutiny and oversight of utility expenditures, operations and investments to attempt to achieve the desired performance levels and customer satisfaction. The commission prefers the former but unfortunately, at the present time, believes the lack of a strategic and sustainable business model would require more of the latter until there is evidence of an acceptable course correction.

To this effort, the commission is committed to work collaboratively with the HECO Companies, Consumer Advocate, and other stakeholders for timely regulatory responses and action. The commission remains committed to alternative regulatory

mechanisms to minimize regulatory lag and uncertainty and is open to innovation to streamline the ratemaking process to the extent they would be in the public interest. However, the achievement of a high performing, customer focused and financially viable electric utility with affordable rates is the responsibility of the electric utility management, not the commission, to deliver on its responsibilities and obligations to uphold the regulatory compact. The public interest demands no less.

CERTIFICATE OF SERVICE

The foregoing order was served on the date of filing by mail, postage prepaid, and properly addressed to the following parties:

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